THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS

SUMMER 2003 · VOLUME 6, NUMBER 2

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Rutgers—The State University of New Jersey
The Official Journal of the Ludwig von Mises Institute

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Volume 6, Number 2 Summer 2003

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WIESER ON ECONOMIC CALCULATION UNDER SOCIALISM

SAMUEL BOSTAPH

A controversy exists concerning the extent to which Ludwig von Mises and Friedrich A. Hayek differed on essential theoretical elements of their respective understandings of the market process.[1] One intriguing aspect of the debate has been the question of the degree of Friedrich von Wieser's influence on Hayek's intellectual development.

Salerno (1993) alleges that Wieser's influence was "considerable," as illustrated by the fact that such influence is clearly evident in Hayek's 1926 contribution to the discussion of the imputation problem, as well as in framing his basic approach to the theory of capital. Salerno notes that such influence also appears in Hayek's adoption of Wieser's device of an omniscient and totally rational planner of a communist economy for Part II of *The Pure Theory of Capital.* In addition, Salerno (1999) argues that Hayek introduced the "Walrasian general equilibrium approach" of his "revered teacher" to his colleagues at the London School of Economics in the 1930s–to the detriment of Mengerian price theory–and was himself never able completely to break free of such an approach. Additional arguments for Wieser's use of a general equilibrium framework and his influence on Hayek's own adoption and use of that framework are made in Salerno's rebuttal (2002) to Caldwell (2002).

The more general dispute concerning important differences between Mises and Hayek seems to have been stimulated by Kirzner's (1987) insightful observation that the socialist calculation debate served as an important catalyst for the development of a distinctly Austrian School understanding of

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[1]The main contributions in the ongoing controversy are Boettke (2000); Caldwell (2002); Herbener (1991, 1996); Hoppe (1996); Kirzner (1987, 1996, 1999); Rothbard (1991, 1994); Salerno (1990, 1991, 1993, 1994, 1996, 1999, 2002); and Yeager (1994, 1996, 1997).

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the nature of the market process. Although not restricted to that literature, contributions by Mises and Hayek to the calculation debate have been extensively used and referenced in the more general argument concerning their respective understandings of the market process. This is especially true with respect to the question of the central weakness of the theoretical case for socialism. Simply put, the question is: "Does socialism face a calculation problem, a knowledge problem, or both; and, which is dominant in making rational economic choice impossible in higher order goods production?" Of course, a subsidiary question concerns the particular meanings assigned to those terms respectively by Mises and Hayek.

Although the formal debate between Austrian School economists and socialist and neoclassical economists over the theoretical possibility of economic calculation in a socialist economy began with Mises's 1920 article, the question of how production could be planned in a socialist or communist economy already had a long history. Most interestingly for the present argument, Friedrich von Wieser was an early participant in the discussion. In *Natural Value* (*NV*) in 1893 (1971) and *Social Economics* (*SE*) in 1914 (1967), Wieser sought to use the new value theory of Carl Menger as a key component in an argument for the possibility of economic calculation in a socialist or communist system. In so doing, Wieser presented an argument for "natural value" as the unit of calculation and for "imputation" as the method of deriving the values of higher order goods from the "natural values" of first order goods. He also assumed a general equilibrium context in his theoretical explanation of how socialist or communist economic planning using "natural values" could take place.

Salerno (2002) identifies the key features of the "verbal general equilibrium" context within which Wieser attempted to construct a case for economic calculation under socialism or communism, most notably in his *Social Economics*. Salerno also highlights the importance of Wieser's concept of imputation within a "simple economy" of socialism, as well as Hayek's 1926 acceptance and defense of it as a means for organizing production in a nonmarket economy. Notably, Hayek continued to use Wieser's "simple economy" of socialism as an analytical device as late as 1941 in his *Pure Theory of Capital*, and to assume as late as 1945 (1972, p. 85) that an omniscient planner in such an economy could impute values from first order goods to higher order goods.

The purpose of this present article is to review and critique Wieser's concepts of "natural value," "imputation," and the "simple economy," and to show their departures from Mengerian thought. One of its main conclusions is that Wieser fails in his attempt to develop the legacy of Carl Menger to provide theoretical support for socialist or communist planning. That is, Wieser fails to show that economic calculation is theoretically possible under socialism.

Specifically, it will be argued that Wieser's concept of "natural value"—a concept apparently derived from his attempt to understand and extend marginal utility theory beyond Carl Menger's use of it in his own theories of value,

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exchange and price—is incoherent. It is also argued that, rather than being an improvement on Menger's theory of imputation, Wieser's approach is spurious and confuses imputation with a static theory of distribution. Further, it is shown that Wieser's theory of the "simple economy" in *Social Economics* collapses into an attempt to outline a static allocation model of a "Robinson Crusoe" economy that fails because it includes the key errors of *Natural Value*.

In sum, the nullification of Wieser's explanations of value, price, and exchange nullify his dependent arguments for the feasibility of economic calculation in a communist or socialist society and for state planning of production. In closing, I argue that Hayek's acceptance, defense, and use of such obvious and fallacious departures from Mengerian thought may account for Hayek's emphasis on the knowledge problem, rather than the calculation problem faced by socialism, in contrast to the position taken by Ludwig von Mises.

Value and Marginal Utility

Total Value of a Stock of Goods

At first glance, Wieser's *Natural Value* seems a relatively straightforward presentation of the early Mengerian version of the marginal utility theory of value, focusing on some of its implications for the theory of production—implications that extend the work of Carl Menger. A more thorough examination reveals this view to be mistaken.

In Book I, Wieser hypothetically examines the actions of an individual valuing person and has been taken to task most notably for his argument (1971, pp. 25 and 34) that the total value of any stock of goods is a multiple of the marginal utility of the marginal unit evaluated.[2] The marginal unit is the one that obtains its subjective value from its (potential) use(s) to serve the lowest-ranked purpose(s) of the evaluator that is(are) possible, given the stock.

As Wieser himself recognized (in Chapter X "The Paradox of Value"), his method of calculating total value creates a paradox because removing the (current) marginal unit of a stock from consideration may increase the total value

[2]See also Wieser's later (1891, p. 109) summary statement of this calculation. Critics of such a procedure have either argued that (Böhm-Bawerk, vol. II, p. 148, n. 25 and vol. III, pp. 81-83) total utility is actually found as a sum of the marginal utilities of all units evaluated, or that (Rothbard, pp. 269-70) the concept has no usefulness at all because units of a stock are evaluated by decision-makers one at a time, not *in toto*—and if they were evaluated *in toto*, they would then collectively be the marginal unit, and their collective utility a marginal utility. See also Mises (1966, pp. 120-23). It might also be pointed out that although total revenue (price times quantity) is useful for accounting purposes, total utility—being a psychological magnitude, if a magnitude at all—is not and cannot be so used. Hence, why bother with any attempt to calculate it? But, Wieser's interest is in total value, not total utility. The importance of the difference will be shown below.

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of the stock. This is because the unit that becomes the new marginal utility multiplicand is necessarily more highly valued than the one removed. Although one is now multiplying it by a stock size smaller by one unit, the lower value of the multiplicand removed could be more than offset in the calculation of total value by the higher value of the new marginal utility multiplicand.[3]

Wieser's justification for his method of calculating total value, and explanation for why there really is no paradox, is to claim that each addition to the stock of a commodity has both a positive and a negative "element" to it. Positively, it adds its enjoyment to the total enjoyment possible through using all the goods in the stock. Negatively, it makes the marginal unit fall in value because (p. 30) "all the single items of a stock are considered only at the value of their marginal utility" as we shift our attention from the uses of the goods to "the goods themselves." And here he discovers a "surplus value." It is the difference between the value of the services to be obtained from the goods and the value of the goods themselves. The former is determined by the uses to be made of them; the latter by their relative scarcity. As the stock of units of a good increases in number from zero, men value the total of all units of the goods they possess according to the marginal utility of the marginal unit. Since all similar goods are interchangeable at the margin, each can be regarded as the marginal unit and thus the total value of the stock is its size times the marginal utility of the marginal unit.[4]

To be specific, Wieser argues that a stock of size one has a total value equal to its marginal utility. A stock of size two has a total value of two times the marginal utility of the (interchangeable) marginal unit–and this is necessarily less than the marginal utility of the first unit acquired (when one only acquires one unit) plus the marginal utility of either of the two when one has acquired two units. The difference in total value between the two situations is the "surplus value" that is lost as scarcity decreases. It is easily seen that as the stock increases, the "positive element" of the value of the marginal unit is increasingly offset by the "negative element" of the fact that there are now many total units and we are losing interest in them as individuals–as shown

[3]Wieser's calculation example (*NV*, pp. 27-28) suggests that he is really thinking in terms of exchange values (prices) rather than marginal utilities, although he argues he is calculating the total value (in utility) of the stock. Like total revenue calculations, the totals he calculates rise, reach a maximum and then fall to zero as the number of units of the good increases from zero to 11. Ekelund and Hébert (1990, p. 330) assume that Wieser means prices when he refers to units of value or marginal utility.

[4]If one is not thinking of the personal uses to which goods are to be put, but of the marginal utility of the (interchangeable) marginal unit, and regards this as affected most by relative scarcity, it would seem one is really thinking of the exchange value of the marginal unit instead of its marginal utility. And this reinforces the point made in the previous note. Problems with this way of conceiving marginal utility are addressed below.

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by the fact that beyond some point the total value of our stock ceases to rise and begins to fall.

Of course, this is a bogus argument and the fluctuation in total value is entirely due to Wieser's method of calculation and not to any "surplus value" lost through changing perspective. The interchangeability of units of a stock of goods does mean that before a decision is made to use a particular unit for a particular purpose, each can be considered to be the marginal unit. Shifting our attention from one to another unit, each would seem to have the same marginal value as any other. But, the enjoyment possible through use of one unit as the marginal unit is not the same enjoyment as that possible through the employment of another unit, once one has decided on the use of the first unit. So, the multiplication of the marginal utility of the marginal unit by the number of units possessed is uninformative of the total enjoyment possible through the use of all units in one's possession for all purposes one has. Why, then, would it be argued by Wieser to stand for the total value of all units possessed?

Usefulness and Value

The root cause of Wieser's error, and of others that fatally flaw the main argument in *Natural Value*, is the way in which he verbally separates the subjective "value" of a good from its marginal utility, so that a unit of a good is said to have "the value of its marginal utility"–as if the "value" of a good is something separate from its marginal utility, but capable of being made equal to it.[5] This treatment begins with his reference (pp. xxxi-xxxii) in the "Author's Preface" to "the old proposition, that the value of goods comes from the Utility of goods, or–what is the same thing–from the satisfactions of want which goods assure." There, Wieser refers (p. xxxii) to the forerunners of the new theory of value (the marginal utility theory) as "those who take up the question of quantities of goods as well as their utility." Thus, it seems he means the word "utility" to refer to objective characteristics of the good that make it useful, rather than to the results of an evaluation of the relation between the amount of the good and the purposes that may be achieved through its use.[6]

In Chapter III, Wieser sketches a hierarchy of wants and argues the satiability of each category according to "Gossen's Law." This is followed by a statement in Chapter IV (*NV*, pp. 10-11) that one could "mark every separate act

[5]If the subjective "value" of a good is something other than its marginal utility, Wieser never indicates exactly what. He does argue that the value of a good is derivative of the value of the want that it is used to satisfy; but, surely the value of its use to satisfy that want at the margin is what is meant by its "marginal utility."

[6]This interpretation is confirmed when Walras, Condillac, Genovesi, and Senior are listed as examples of writers who show (*NV*, pp. xxxiii) that "'scarcity,' 'limitation of supply' is recognised as the condition under which utility creates value." In addition, it is noteworthy that in the beginning paragraphs of Chapter I, "utility," "useful," and "value-in-use" are used interchangeably.

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of satisfaction with the value that accompanied it," and so "obtain a diminishing scale." (This approach itself will be criticized below.) Arguing that (*NV*, p. 12), "classes of goods correspond to classes of wants, and judgments concerning the importance of classes of wants will correspond with judgments on the usefulness of classes of goods," Wieser, nevertheless concludes that even some of the goods of "the highest usefulness" will "be put only to a very trifling use" It seems clear that he equivocates in his use of the term "useful." So far as his application of the term to a particular class of goods, he appears to mean by its "usefulness" its importance. And this is determined by the importance in the hierarchy of all wants of the particular wants to be satisfied using goods of that class. There is no value connotation attached to individual units of goods here. So far as application of the term to those units of goods in a particular class that are used to satisfy a particular category of wants, he appears to mean by "useful" that each unit is able to secure a particular level or amount of satisfaction of a certain want. There is a value connotation here, and this is shown by the phrase "a very trifling use." So, what is actually meant is that a highly ranked want can be satisfied to the point that the marginal unit of a good used to satisfy that want provides very little additional satisfaction.

This seems unobjectionable, so far as it goes; however, there remains a second issue–the question of how one could "mark every separate act of satisfaction with the value that accompanied it." Satisfaction is a mental state that results from mental or physical actions taken to achieve ends. Satisfactions do not occur without cause, although one can abstractly contemplate them as they occur (or recall them by memory and use them in imagination). Certainly, satisfactions can be subjectively ordered or ranked ordinally, as can degrees of satisfaction. But, ordinal ranking is not cardinal measuring–which measurement Wieser implies. Further, the "value" of a satisfaction lies in its contribution to some believed overall state of well-being–and this is not cardinally measurable either. So, the "value" being referred to by Wieser as some sort of abstract measurement cannot be the same sort of thing as the value attributed to a good used to achieve a particular (ordinal) level of satisfaction. The latter is the "economic" value to which theories of value in economics commonly refer.[7]

[7]Wieser appears to recognize this at the beginning of Chapter VII, when he asserts (1971, p. 19) that man's interest in things is reflected in "economic valuation, when things are conceived of as instruments to and conditions of human well-being . . . as means to human ends." And (*NV*, p. 20), where he says that it requires a "special compulsion" for us to regard things as "objects possessing value." The "special compulsion" is, of course, that of scarcity. Mises (1935, pp. 96-97) is characteristically direct in denying the possibility of "a unit of subjective use-value for goods [because] judgments of value do not measure; they merely establish grades and scales." It is "the objective exchange-value of commodities [that is] the unit of calculation." See also Mises (1935, pp. 98, 104, and 107-08; 1951, pp. 114-15 and 211).

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Value and Utility

Wieser's early ambiguities in the meanings of "utility," "value," "usefulness," and "use" are followed in later chapters by an attempt to conceptually separate "value" and "utility" that only succeeds in emptying the word "value" of any content whatsoever.

The attempt is presaged by a statement (*NV*, p. 21) at the end of Chapter VII that "goods . . . receive value from that value which their employments have." He goes on to assert (ibid.) that the value of goods finds its origin in use, but does not necessarily reflect their utility (apparently meaning some hierarchical sense of "usefulness," as he later says that the particular use of a good can be "far removed from its general usefulness"). The task of the economic theorist is then given as explaining value by examining "those laws by which amounts of utility are changed into amounts of value."

This he attempts to do in Chapter IX where he uses the fact of scarcity to produce the marginal utility theory of value. However, in his presentation he uses examples where he assigns numbers to degrees of satisfaction and refers to them as "marginal utilities." Those same numbers are then used to signify the values of the units of the commodity in question, concluding (*NV*, p. 26) that "this law of value unites the conceptions of value and of utility in a way that is fully confirmed by facts." For illustrative purposes, the use of numerical examples is unobjectionable; however, when Wieser uses them (*NV*, p. 25) to argue that the total value of a harvest is equal to the numerical value of the marginal satisfaction times the size of the harvest he is using a method of calculation appropriate to totaling exchange values, not summing marginal utilities.

That Wieser is implicitly doing the former is apparent when he argues (ibid.) that "the use obtained from free goods represents no value whatever."[8] If a good is free (meaning that its exchange value is zero), of course it will be used, by those who desire it, until its marginal utility is zero. It is the fact that it is not scarce that makes it a noneconomic good for its users, and thus not a subject of exchange. As Menger noted (1976, p. 100), "men are communists whenever possible under existing natural conditions." The total value of noneconomic goods (calculated Wieser's way) will also be zero, because any number times zero is zero. It is the zero exchange value and consequent zero marginal utility that makes this possible; however, if the exchange value of each (interchangeable) unit is at all positive (that is, if the good is an economic one), the total exchange value may be found by multiplying the price by the number of commodity units in question. Contra Wieser, one cannot find the total economic value of the goods to the evaluator that way, as previously argued.[9] It is even possible that a good can have a zero marginal utility

[8]See also p. 70, where the same claim is made for free production goods. Compare Mises (1971, p. 45).

[9]Even if the marginal utility of any particular unit of a free good was zero, the total value calculated either as a sum of the subjectively-determined expected marginal values

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for a particular person because it can provide no satisfaction to him directly, but have a positive economic value. If it has a positive exchange value, it can be traded for other goods that can provide satisfaction to him directly.[10]

Subjective and Objective Values

The footnote (*NV*, p. 26) at the end of the Chapter IX reveals the ultimate purpose of Wieser's idiosyncratic explanatory method in Book I. Because its implications extend throughout the rest of *Natural Value*, and are foundational to *Social Economics*, it is worth quoting at length:

> We have here reached a decisive point in our explanation. Experience shows us daily that similar goods obtain similar prices; and the majority of theorists . . . are agreed that these prices are fixed by a marginal law. In this is involved that exchange value, which rests on prices, is the same for all similar goods, and obeys a marginal law. We, however, have gone still further, and say that Value generally and in every form, even in that of use, and even where there is no exchange–as *e.g.* in a community organised on a socialist basis–*must be the same for all similar goods* [emphasis added], and must obey a marginal law. . . . There is just one more point to which I should like now to draw special attention. Price not only regulates the amount paid by buyers, but also the amount of production by sellers: it gives to the latter its level. All goods produced for the market are produced under a valuation which considers similar goods as equal to one another, and which subjects them to a marginal law, and it is with reference to this valuation that the costs permissible are calculated, that all stocks are inventoried, that all undertakings make up their balance-sheets, and that all profit and loss is reckoned. If a socialist community were to give up exchange–the payment of buyer to seller–*it would not on that account require to give up this measuring scale for the valuation of goods* [emphasis added]. It could continue to value similar goods at the same figure, and to bring them all under a marginal law. (Wieser 1971, pp. 26-27)

Three points are relevant here. First, "exchange value" does not "rest" on prices; "exchange value" is what is meant by "price." Second, it is usually the case that exchange value is the same for all similar goods for the individual buyers or sellers buying or selling them. However, similar goods are only substitutable in use for the one person possessing and evaluating them, and their marginal values may differ from one evaluator to another. As Menger argues in his *Principles* (Chapter V), exchange value (price) is only a historical artifact.

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of all units in one's stock (as Böhm-Bawerk would have it), or as the stock evaluated either individually or in toto (as Rothbard or Mises would have it), could be positive. Compare *Social Economics* (1967, pp. 127-28), where it is argued that if a planned production process was expected to provide a superabundance of product (such that marginal utility would equal zero), it would only be undertaken in light of its "total benefit" or "total utility" to the community.

[10]Wieser (1965, p. 323) earlier made this exact point in his reply to Professor Macvane's critique of Austrian value theory. Also see Schumpeter (1989, pp. 6-7) on the effect on individual utilities of market exchange.

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It tells us that at the time an exchange occurred, the traders valued the goods they received more highly than the goods they gave up, and were willing to make the exchange at the rate agreed upon. It does not tell us how the individual trader's marginal values compared to those of any other trader. Value only obeys a marginal law to the individual evaluator in the act of evaluation.

Finally, it is difficult to understand what Wieser means by saying that (*NV*, p. 26). "Value generally and in every form, even in that of use, and even where there is no exchange . . . must be the same for all similar goods, and must obey a marginal law." Values are the result of evaluation by an individual person. The law of marginal utility applies only to the evaluation process of such an individual. Marginal values are the subject of the law of marginal utility and interpersonal comparisons of the values obtained cannot be made. Thus, "value generally" cannot be the same for all similar goods in the absence of exchange because there is no "value generally" justified by the law of marginal utility under that circumstance. This means that if a socialist community were to give up exchange, there would be no basis for the calculation of costs or "values"–except for each individual evaluator, who would still calculate subjective values the same way as in a market economy. However, because "the measuring scale for the valuation of goods" is a subjective one, the "community" could marginally value nothing, whether it attempted to use a marginal law or divine revelation. For "community" valuations, accounting balance sheets and profit and loss calculations to be made up, exchange values would be required as input.

Thus, Wieser's attempt to place the socialist community on the same footing as that of the market economy fails at the outset. Wieser's confusion between (subjective) marginal values and (objective) exchange values that appears to stem from his conceptual ambiguity concerning value and utility has produced a foundationless claim for socialism. Unfortunately, it similarly dooms his basic thesis of "natural value," as will be shown next. And, as argued later, this ruin of "natural value" has serious implications for the concept of the "simple economy" that is employed by Wieser in his theory of state planning. This is especially the case in his *Social Economics*, where he attempts to use the theory of the "simple economy" as a springboard to a theory of the socialist economy.

"Natural Value"

Exchange Value

It is in Book II of *Natural Value* that Wieser attempts to define and explain the "natural value" that gives the title to the entire work. This only occurs after five chapters of an attempt to explain "exchange value" so that it may provide a contrast to "natural value." In the process of that attempt, Wieser aptly explains how the marginal utility principle leads potential buyers and potential sellers in a commodity market to settle on a price that is slightly lower than the marginal value of the good to the actual buyer who values it the least,

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but slightly higher than the marginal value of the good to the potential buyer who decides to forgo the purchase. However, in contrast to Menger's treatment of the same subject, Wieser's presentation assumes the existence of money and emphasizes the importance of the wealth and income of the potential buyers and sellers as determinants of their success in exchanging money for goods. It is the distribution of wealth that determines the distribution of production in an exchange system–and this to the detriment of "the poor," Wieser concludes.

He proceeds in this way: Assuming that exchanges are made by means of money, Wieser examines the valuation of money itself and explains it using the marginal utility law. This produces the obvious decline in the marginal utility of money with increases in the wealth and income of the evaluator. But, rather than stopping with the recognition that money is no different in this respect from other commodities, Wieser goes on to a further point; he wishes to contrast the exchange values, or prices, of goods with their subjective values in an exchange system using money. In such a system, he asserts (*NV*, p. 57), "Value in use measures utility; exchange value measures a combination of utility and purchasing power." The result of this is that (*NV*, p. 58) "the distribution of wealth . . . decides how production is set to work." "The rich" pay the same prices as "the poor" for necessities–whose prices are set, he asserts, by the weakest (usually, poorest) buyers at the upper margin of their subjective valuations–and this is less than the goods' "personal valuation" to "the rich." Their leftover means are in this way available to "pervert" the distribution of production toward luxury goods and thus provide a "defective impulse" of consumption to production.

Exchange Value vs. "Natural Value"

The implication to which this leads is that (*NV*, p. 59), "while, in the individual household, the marginal line is drawn *naturally*, in economic life generally it is influenced also by the manner of the distribution of wealth" (emphasis added).[11] Thus, Wieser has set the stage for the discussion of "natural value" in contrast to exchange value, which is (*NV*, p. 62) "a caricature of natural value." And, what is this lauded "natural value"? It is (*NV*, p. 60) "that value which arises from *the social relation* between amount of goods and utility, or value as it would exist in the communist state" (emphasis added). Somehow, in "the communist state" goods "would rank in value according to the relation in which *the available stocks* stood to the demand; and that relation would express itself finally in the marginal utility" (emphasis added). Again, "social supply and demand, or amount of goods and utility socially compared with one another, would decide value." And most tellingly (*NV*, p. 61), "natural

[11]Wieser makes a similar argument in *Social Economics* (1967, pp. 178-89) and extends it to discuss how the "strata of income and wealth" produce a "stratification of prices" that departs from "a rational social appraisal of dependent need values." Cf. his earlier discussion of price and value (1891, pp. 116-18).

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value shall be that which would be recognised by a completely organic and most highly rational community."[12]

If ever a grand economic thesis begged for precision in explanation, this is the one. And yet, what is seemingly presented here as "natural value" is marginal utility as determined in an ant colony. Or, perhaps, marginal utility as determined in a society composed exclusively of humans replicated from a single subject. What has become of the caveat of the note (*NV*, p. 52) in Chapter III, where Wieser had argued that the economic importance of goods is found in "their relation to wants . . . but this relation to want can only be realised and measured individually"? Why, Wieser has cut the social Gordian knot by hypothesizing a super-individual determination of marginal utility for each good existing in a society without property or exchange. And for what purpose has this been done? So that he might present (*NV*, p. 61) "the communistic state as the perfect state," inasmuch as "natural value . . . is disturbed by human imperfection, by error, fraud, force, chance . . . by the existence of private property, and by the differences between rich and poor" when exchange values are established in a market economy.

Underlying Wieser's attempted contrast between "exchange value" and "natural value" are two key errors and one important omission. The first error has been discussed above, where it was argued that Wieser confuses (subjective) marginal value calculations with (objective) exchange value calculations in an attempt to "socially objectify" subjective value. It is that confusion which makes Wieser's concept of "natural value" merely redundant if it is intended to refer to the subjective marginal value calculations of the individual, but incoherent if it is intended to represent some sort of "social" marginal utility. Human societies are not ant colonies, and they are not formed of replicants. And Wieser has here provided no basis for a super-social calculation of marginal utility (although he attempts to do so in his later theory of the "simple economy" in *Social Economics*).

Wieser's second error stems from a fundamental misunderstanding of price formation in a market economy. In a completely free market economy, exchange values are the prices established by marginal buyers and marginal

[12]At the very end of *Natural Value* (p. 242), Wieser admits that "natural value" is a fiction; however, it is never made clear exactly what sort of fiction. Is it a fictional value assigned by an omniscient intelligence who "knows" what is metaphysically best for each person, and, therefore, what their marginal valuations should be? Or, is it a fictional value that reflects each person's evaluation (right or wrong for them in some metaphysical sense) of the marginal utility of every possible amount of a good, and that is known by the omniscient intelligence? Each of these implies a "communist state" that differs significantly from the other. *Social Economics* (pp. 9-10) suggests that the first interpretation is the applicable one. Schumpeter (1989, p. 1, n. 2) opines that "'natural value' is a kind of 'social value'," asserts (p. 4) that a communist society would have "social utility curves" and would use "social value" and "social marginal utility" for production and distribution decisions and describes (p. 12) Wieser's theory as "thoroughly sound."

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sellers in each market. But, a marginal buyer in one market may be an above-marginal buyer in another market, this classification depending on differences in the marginal utility assigned to different commodities by that buyer, as compared to the opportunity costs represented by market prices. And this means that it may be the case that a "poor" person who is the marginal buyer in one market pays a price just lower than the marginal utility of the commodity to him, while other buyers–who pay the same price–pocket large individual consumer's surpluses in that market. But, the "poor" person in one market could just as well become a "rich" person in another market, depending on his preferences and budgeting decisions–as well as his income and wealth positions.

It is in the nature of free markets to generate consumer and producer surpluses. That is why people trade, as Menger pointed out in the process of confuting the labor and other "objective" theories of value. And a single trader's consumer or producer surpluses may differ from the market for one commodity to the market for another. It is arbitrary, then, to label some traders "the rich" and others "the poor" and see in their differing preferences and consumption decisions a defect in the normal operation of a nonprice-discriminatory market.[13]

The omission in Wieser's attempt at contrast between "exchange value" and "natural value" is the basis for the assumption that there are "available stocks" of goods to receive their "natural value" marginally in the communist state. The theory of production and supply is inseparable from the theory of value in an exchange economy; and, as will be shown below, Wieser never provides a compelling argument that the same is true in the communist state. If "natural value" can be conceived only under the assumption of an arbitrarily determined stock of goods somehow made available to demanders, it cannot be compared fairly with exchange value.

"The Rich" vs. "The Poor"

More importantly for the basic point he wishes to make, Wieser also argues (*NV*, p. 58) that because the marginal utility of money is lower to "the rich," they provide a "defective impulse" to production and thus disadvantage "the poor," to whom the marginal utility of money is much higher. This is another false argument that flows from the same basic misunderstanding of how free markets work. It could be said that the presence of more than one

[13]This is no denial of the fact that some have low and others high incomes and wealth holdings. It is a denial that that fact has any bearing on the general principles of exchange–which are the same for free markets in bread as well as in yachts. Some higher income earners do not buy bread; and some lower income earners save for years in order to buy yachts. Both markets exhibit the same principles of exchange, if they are free. Those who enter markets do so with varying endowments of tastes, preferences, wealth, intelligence, education, incomes, information, and purposes. They leave with varying gains. One might equally argue that consumers with bad tastes "bias" markets against the educated and refined. Cf. Reisman (1998, pp. 204-06).

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demander in a market disadvantages each demander because the added competition bids up the price from what it would have been if there was only one demander. And, if one of two demanders dedicated more of his budget to that market, the other competitor would be doubly disadvantaged. Or, it might be said that among demanders for cloth, because tastes differ, the demand for varying materials, colors and weaves on the part of some demanders provides a "defective impulse" to production; it drives up the prices paid by all those who would be satisfied to purchase only plain white cotton cloth–if all textile industry resources were dedicated solely to its production.[14] Both of these statements may be true, but they are trivial. What is being described is how free markets work, whether traders are arbitrarily labeled "the rich" and "the poor" or not. No one demander has a right to a certain price or product characteristic that is violated in some way by the presence of other demanders, whatever their wealth or income status. And, thus, the use of the value-loaded verbs "pervert" and "disadvantage," and the term "defective impulse," to characterize price formation in a free market is inappropriate moralizing at the least.

Not to belabor the point, but assume a class of demanders arbitrarily labeled "the poor." If Wieser's argument was correct, we could just as well regard each member of "the poor" as a detriment to others in selected markets. For instance, those members of "the poor' with strong preferences for housing compared to nutrition bid away resources from those whose relative preferences favor nutrition; they do this by raising the costs of erecting grocery stores. This, in conjunction with a given demand for groceries, will raise the price of groceries to "the poor" who favor nutrition. Among "the poor" who demand groceries, some will be willing to pay more for milk than others but, following Wieser's logic, will only have to pay the same low price as those who are not willing to pay more. The marginal milk demanders will have only a small consumer surplus as compared to "the rich" milk demander, who is willing to allocate a larger portion of his budget to milk, but doesn't have to, and so can compete to buy beer in the "luxury" beer market.

Of course, Wieser's argument concerning the marginal utility of money also involves interpersonal comparisons of utility and thus cannot be proven. Although there is general agreement among economists that the marginal utility of money to any one person falls with more of it,[15] there is also general agreement that it is not possible to compare one person's marginal utility of money with another's–whatever their respective wealth or income positions.

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[14]I once heard a senior member of an economics faculty make this very argument, and protest irately at the injustice of consumer-driven product differentiation.

[15]Whether the marginal utility of money declines with absolute increases in income (Friedman and Savage 1948) or with relative income increases (Marshak 1951), interpersonal comparisons of utility are not possible (Alchian 1953).

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Finally, in regard to the law of one price as it applies to resellable commodities, the reason for one price is that sellers who attempt to discriminate among buyers will create their own competitors. Thus, the seller who would ask more of "the rich" buyer than "the poor" one will find the self-interest of both leading to "the poor" one becoming a supplier to "the rich one." "The rich" buyer willingly switches suppliers in spite of the low marginal utility of money to him because it is quite rational to release money from one use so it can be used for other purposes. "The poor" buyer becomes a supplier because more money is better than less, despite the accompanying decrease in the marginal utility of money.[16]

IMPUTATION

Wieser's Critique of Menger

The ambiguities and errors that plague Wieser's attempt in Book II to conceive a "natural value" to displace exchange value in economic calculation also plague his theory of imputation in Book III. Beginning his own treatment on a foundation laid by Menger, and despite an avowed intention to generate a theory of imputation of economic value, what Wieser does in this book is to confuse the issue with the question of distribution.[17]

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[16]In *Social Economics* (1967, p. 185) Wieser attributes the establishing of "the general price" in a market to "socially controlled egoism." There is a just and equitable price that all agree on for the general benefit.

[17]This is even more clear in his later (1891, p. 110) statement that imputation makes possible "the distribution amongst the separate effective factors of [the] joint return." See also (ibid., p. 119). Streissler (1990, p. 59) also apparently confuses the theory of price with distribution theory when he asserts that if we take Böhm-Bawerk as our guide, "early Austrian Economics was practically nothing but a theory of distribution" and references Böhm-Bawerk's *Positive Theory of Capital*. Book III, Part B, Chapter IV of *Positive Theory* (1959, pp. 248-56) is very clear on the difference between the theory of value, the imputation of value from lower to higher order goods, and the theory of higher order goods prices, which result from a market bargaining process. Value imputation provides demanders of higher order goods with a calculated upper limit offer price. Menger (1888, pp. 23-27) is even more dismissive of the relevance of a theory of distribution to one of "economic causation." Mises (1951, pp. 151-52) points out that the question of distribution only arises in a socialist economy. This is because "under Capitalism incomes emerge as a result of market transactions which are indissolubly linked up with production . . . since they arise during the process of production and are indeed derived from it." Under socialism, production and distribution are intentionally separated. See also Mises (1935, pp. 89-90). In contrast, Hayek (1984, p. 34) asserts that "From Ricardo onwards . . . it was knowledge of the determinants of income which constituted the objective of theoretical economics." Thus, "a satisfactory solution of the problem of imputation is therefore the precondition . . . if the theory of distribution is to be definitively established on the basis of the subjective theory of value." Such solution "has to be attempted without recourse to exchange."

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Menger's brief treatment of the imputation of the value of higher order goods from the expected value of the first order goods they are intended to produce is found in Section 3 of Chapter III of his *Principles*. There he argues (1976, pp. 162-65) that the value of any given quantity of a higher order good to the individual employing it is equal to the difference in the expected value of what can be produced given its presence and what can be produced in its absence. This principle applies to the subjective valuation of the services of all higher order goods, whether we label them land, labor or capital.

Wieser's own treatment of imputation proceeds differently. He begins (*NV*, pp. 69-71) by acknowledging that the value of production goods is determined by the expected value of the return from using them; however, in discussing the valuation of given quantities of specific production goods he departs significantly from Menger.

His summary of Menger's own argument not only misrepresents the main point, but also contains an important procedural error. Menger had proceeded marginally; that is, he had assumed a particular production process set in historic time and argued that the value to the economizing individual of *any given quantity* of a higher order good used in that process could be determined as the difference in expected values of lower order goods produced in its presence or absence. This represents a dynamic approach to the practical calculation by an economizer of limits to the value of particular amounts of higher order goods; it is not a theory of pricing or of distributive shares.[18] Wieser's approach is different.

Using a numerical example, he assumes (*NV*, p. 83) that three higher order goods could together in their best use produce 10 units of value; whereas, used separately in other processes they could collectively compensate for the loss of 10 value units by an increase of nine, at a rate of three each. Obviously, this is Wieser's justly acclaimed concept of opportunity cost at work. The opportunity cost of removing the three goods from other uses is three value units each. Wieser then claims that Menger would attribute instead a value of four to each good because if one were lost, the other two would only compensate the loss of 10 by an increase of six. Since any of the three could be the lost one, they would thus have a collective value of 12, which is impossible. Instead, Wieser assumes (*NV*, p. 85, n. 1) a collective value of 10, from which if nine is subtracted there is a surplus of one.

This critique ignores two things. First, Menger's dynamic, process-oriented analysis is ignored by a static calculation of collective value as three

[18]Böhm-Bawerk (1959, III, pp. 88-89) recognizes this difference and uses it to rebut Wieser, while Hayek (1992, pp. 114 and 116) applauds Wieser's attempts to expand value theory to produce a theory of distribution and (1984, pp. 39-42, 51) recommends Wieser's solution over that of Menger and Böhm-Bawerk. Mises (1951, pp. 139, 196, 201 and 205) is steadfast in arguing that economic calculation is solely a problem of economic dynamics. So much for Sweezy's (1934, p. 176) judgment that the early Austrians agreed "on all matters of fundamental importance."

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times the "lost" value if any one of the three goods were removed from production. If any one of the three were removed, four units of value would be lost. If one of the remaining two were then removed, three additional units of value would be lost. Obviously, if all three were removed, 10 units of value would be lost, not 12. Second, Menger is not attempting to calculate distributive shares to the cooperating factors, as is obviously the case with Wieser. Such a calculation requires a theory of factor pricing and Menger's brief treatment of imputation is part of his theory of value, which occurs before his theory of price.[19]

Wieser's Imputation Theory

In fact, what Wieser then attempts is a different enterprise from Menger's; Wieser attempts to construct a theory of distribution using a theory of imputation. He presents a solution to the imputation problem that completely departs from Menger's marginal approach and, in fact, drops the marginal utility theory of value completely. The deadfall that leads Wieser into that result is his introduction in Chapter V of Book III (*NV*, p. 88) of a set of three simultaneous equations as a supposed improvement over Menger's method of determining the value of higher order goods. The solution of these equations is asserted to provide the respective amounts of "the total value of the return" to be imputed to each of the cooperating productive factors. The equations are:

$$x + y = 100$$
$$2x + 3z = 290$$
$$4y + 5z = 590$$

Where $x = 40$, $y = 60$, $z = 70$

Wieser claims that each of the equations expresses a combination of the factors of production on the left side and the value of the returns on the right side. He asserts that this approach reveals "the productive contribution" of each factor of production, which is "that portion of return in which is contained the work of the individual productive element in the total return of production." Thus, "If we add together all the equations, the total amount of productive wealth will stand as equivalent against the total value of the return."

[19]Menger asserts (1976, p. 173) that he will explain the pricing of the services of land, labor, and capital–as compared to the values of those services–later on; and, that the general principles of that pricing are the same as those for commodities. This explanation is never provided, although it was to be included in a second part of the treatise of which his *Principles* was to be the first part. His criticisms of Ricardo and (by implication) Malthus (pp. 167-72) are only suggestive of the explanation he may have intended to present. See also Böhm-Bawerk's (1959, III, pp. 80-84) response to Wieser's critique and Mises's (1951, pp. 121 and 154) and (1966, p. 335) argument that value imputation cannot be used under socialism to divide up the value of a joint product among complementary factors.

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For this actually to be the case, the left and right sides of the equations must be commensurable; that is, either the variables or the coefficients on the left side of the equations must be denominated in the same value units as the values on the right side of the equations. What is Wieser's standard of commensurability?

Unfortunately, his presentation is ambiguous on this point and several interpretations of the meaning of the terms in the equations are possible. Nevertheless, there are only three possible standards that would fit what these equations mathematically represent–and they are mutually exclusive. Either the left and right sides are commensurable in terms of physical units, or they are commensurable in subjective value units, or they are commensurable in terms of monetary units.

If x, y, and z are physical or subjective value units, then 40 of x and 60 of y will sum to 100, and so on with the other two equations. Assuming that they are physical units of input does not agree with Wieser's claim that the value of the returns is shown on the right side of the equations. Assuming that they are subjective value units begs the question of how such subjective values have been objectified in the equations so that value inputs yield value outputs; and, if they can't be objectified, they can't meet their intended use in planning. Only if x, y, and z are assumed to be the monetary values of the inputs, will 40 monetary units worth of x and 60 monetary units worth of y sum to 100 monetary units.[20] The result is a distribution of shares of the price of a unit of output among inputs. But, this division of revenue into factor costs avoids the question of how the factors came to be combined in the fixed proportions in each industry, and the "imputation" method itself cannot be used for industries using variable input proportions. It becomes a mere accounting division of total revenue and also avoids the main question of distribution theory–how are the prices of the inputs determined?[21] Even

[20]Thus, Blaug (1997, pp. 411-12) assumes that x, y, and z are the prices of the inputs, combined in different, but fixed proportions in each of three industries, with the numbers on the right being the respective prices of a unit of output in each industry. Stigler (1941, p. 169) notes that this implies the "absurd" assumption that demand is infinitely elastic at the given prices. He also finds (p. 165) a tendency to vacillate between fixed and variable input proportions, and interprets this to mean that altered proportions imply an altered product to Wieser. Hutchison (1953, p. 156) opines that Wieser was just following Menger's emphasis on the complementarity of production goods but not that on variable proportions, which is required for marginal productivity analysis.

[21]Wicksell (1954, pp. 24-25) interprets Wieser's equations as merely stating that under free competition factor prices "must be approximately the same in in all transactions," but omitting the "how and why." To answer these questions he suggests a method that considers quantitative changes, such as use of the differential calculus. Nevertheless, Euler's Theorem cannot be used to dynamically attribute value or revenue according to marginal productivities of higher order goods in a fixed proportions production process, even if the neoclassical assumption of infinite divisibility of input and output was made.

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more importantly, the Mengerian dynamics are lost and there can be no calculation of marginal product or marginal values.

As a third possibility, if Wieser is assuming that *x*, *y*, and *z* are the respective factors of production, then physical combinations are listed on the left and either subjective value or monetary totals shown on the right of the equations and he is mixing mutually exclusive standards of equivalence. In other words, no "imputation" of shares in the value of output to specific amounts of factor inputs can be done in this case.[22] The "specific effect" of each factor, or of "the amount of the means of production employed," on the value of output cannot be identified this way, as Wieser would be mistakenly (*NV*, p. 87) claiming. The respective (*NV*, p. 88) "share in the return" or "productive contribution" of labor, land, and capital is not thusly revealed.

Imputation as a Planning Tool

Wieser's atemporal mathematical approach deliberately (*NV*, pp. 90ff.) ignores the temporal causal relation between variations in specific amounts of specific productive inputs and the resulting variations in the total value of outputs–the very relation that Menger had attempted to specify in his own theory of imputation. And this leads Wieser to a deeper error. He is led (*NV*, pp. 95ff.) to draw a distinction between "individual imputation" and "consideration of production as a whole." The former term refers to the imputation of shares of output value to specific production goods (their "contribution"); the latter to governmental evaluation of the total employment of all resources (their "co-operation") to produce the greatest possible total value, nationally.[23] He argues (*NV*, p. 95) that individual imputation is less informed of "the whole circle of conditions upon which the production depends, and the whole importance of the co-operation of all the factors." In other words, because he envisions imputation as the solution of a public set of simultaneous equations, Wieser is methodologically driven to the view that national economic planning of "production as a whole" would provide a more knowledgeable use of resources and a greater possible total output value than disaggregated individual planning of privately-owned resources. He sees (ibid.)

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[22]Ekelund and Hébert (1990, pp. 335 and 588) appear to take this to be Wieser's assumption. However, if one assumes that the coefficients of his equations are prices, then *x*, *y*, and *z* could be treated as amounts of productive inputs that, times their prices, yielded certain total revenues. But, how were such prices determined? And, why do they differ among the equations? And, if they are prices, "imputation" still becomes a trivial accounting division of total revenue.

[23]Parallels between Wieser's approach throughout Part I of Book III on "The General Principles of Imputation" and the linear programming approach to the organization of production on a national scale are apparent. See especially (*NV*, p. 89, n. 1) and (*NV*, p. 94). The key difference is that linear programming relates quantities of inputs to quantities of outputs, using fixed technical coefficients of production. It does not relate value of output to amount of input. In this regard, compare *Social Economics* (Wieser 1967, pp. 47-48). Blaug (1997, p. 412) also notes this parallel.

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vast spillover effects in the use of resources that government planning could take advantage of, but individual decision-making would not take into account.

Yet Wieser has provided no means for such national planning. Without assuming an economy in which every commodity can be produced only one way, that the required inputs are available in just those proportions, that output prices are given and that input prices are set by the producers, his simultaneous equations cannot relate specific amounts of factor inputs to total output values, as he apparently thinks they can.[24] Without that relation, shifts of resources would be arbitrary, trial and error procedures. Even more telling is the absence of any recognition of the key role played by input and output prices, and their changes, in affecting resource allocation in a market economy.[25] From this point on (Chapters VII-XIII), a fatal ambiguity is introduced into the argument. It is not always clear whether Wieser is discussing the imputation of shares of total subjective value or total exchange value to categories of production factors, or whether he is discussing the imputation of shares of physical product to the specific contributing factors. What is very clear is that Wieser believes that such imputation can be done in command economies as well as market ones; however, as just shown, he provides no foundation for this belief.[26]

Nevertheless, in Part II (Natural Land Rent) and Part III (The Natural Return to Capital) of Book III Wieser proceeds to discuss distributional questions as if Part I had provided such a foundation. In Part II, he assumes the existence of rent and of prices for land and the produce of land in market economies as well as in communist ones, with no explanation of how such prices are established. With respect to rent, Wieser asserts (*NV*, p. 122) that "the law of a universal land rent, and the universal law of imputation are

[24]And, if they are intended to summarize subjective value imputations, they cannot be objectified and compared as bases for a national plan.

[25]Little short of amazing is Wieser's statement (*NV*, p. 94), "The imputation of return to land, capital, and labour, according to the measure of their respective productive contributions, is a natural economic dictate; it holds in all forms of economic life—in the communistic state as well as in the present one." In the "communistic state" there would be no market exchange prices on which to base values and impute returns, even if Wieser had been successful in his attempt to derive a principle of imputation. Hutchison (1953, p. 247) references and quotes Gustav Cassel on the inability of Wieser's communist state to direct production for this reason.

[26]For example, in Chapter VIII, Wieser asserts (*NV*, p. 98) that in allocating production goods among uses, it is desirable to maximize the marginal utility obtainable. Since the context of his discussion is one of national planning, the implication is that marginal utility values can be objectively measured. Unless Wieser means to refer back to his presentation on "natural value," the implication is unsupported. And, if he does mean such a reference, since "natural value" has been shown to be vacuous, his objectification of marginal utility for resource allocation is spurious.

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identical."[27] Most of this part consists of a review and critique of Ricardo's theory of land rent, with what might be described as "lukewarm approval."[28] Especially curious is his supposition (*NV*, p. 116) that rent (however determined) could be capitalized in the communist state.

Natural Value and the State

Although Book V of *Natural Value* is devoted to an extended and problematic explanation of the relations between production costs and the value of resulting output, little of it seems relevant to the argument of the present paper.[29] What is relevant appears in the very last chapter (XIII) on marginal valuation and the national economy. There, after the frequent use of the terms "value" and "utility" in a particularly ambiguous manner, Wieser finally asserts (*NV*, p. 213) that "exchange value, as expressed in price" is the key form in which the "natural value" of goods is expressed.[30] This is because "If the prices for all similar goods in one and the same market are equal in amount, it is because, in the last resort, the valuations of all similar goods in one and the same economy are equal." A further departure from Menger's conception of the relations between market prices and the subjective marginal value calculations of trading individuals can scarcely be imagined.

Wieser's purpose in making this equivocation is stated clearly: "In so far as prices represent natural value, an enormous and arduous mental labour of calculating the exchange value of things is saved." And why would it be desirable to calculate the "exchange value" of everything produced in a national economy? Because (*NV*, p. 214) a national economy is viewed by Wieser as productive of a sum total of value or utility, when considered as a whole complex of interacting productive activities. The establishment by "individual economic evaluation" of an "equilibrium" of values thus makes it possible for

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[27]His acceptance of the argument that rent is a surplus over costs is clearly opposed to Menger's position in his *Principles* (1976, pp. 167-69) that Ricardo is wrong. Menger argues that there is no difference in the principles explaining the value of land and its services from those explaining the value of any economic good. Yet, Wieser's view is consistent with his critique of Menger's imputation theory (summarized earlier) and, consequently, with the conception of imputation as one principle in a theory of distribution, rather than in a theory of value. See also *Social Economics* (1967, pp. 334ff.).

[28]He faults Ricardo only for not recognizing that capital and labor are always scarce relative to land, and (*NV*, p. 120) for having no "general theory of economy, of value, and of imputation."

[29]Wieser continues the practice of referring to "value" (presumably meaning "subjective value") and "marginal utility" as if they were separate, with marginal utility determining (subjective) value only under specific circumstances. See Section 2 above on problems caused by this attempted distinction.

[30]The same point is made in *Social Economics* (1967, p. 144) as Wieser prepares to move from the theory of the "simple economy" to that of the "social economy."

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all goods to "get imputed and distributed out to them the utility which they give only when co-operating with one another." And this opens the door to the view that, with respect to the production of "value," there exist greater considerations than those of individuals in a national economy. The purpose of Book VI is "to show how far natural laws require that individual economic valuation be complemented by the economical considerations of a community, or, more particularly, of a state."

To do this, Wieser must carve out a sphere for state action. Not surprisingly, he declares that there are conventionally three collective duties given to the state: police and justice, public works, and natural monopolies. The last mentioned, in the form of the "public enterprise," forms a bridge to the communistic state as follows:

A public enterprise is (*NV*, p. 225) a firm, owned and operated by the state, "where any considerable want is concerned while the power to pay is wanting." It charges less than profit-maximizing prices. In its case, "...valuation according to exchange value must be replaced by valuation according to natural value." In the communistic state, because all production and consumption will be under state control, that side of state activity makes the state a public enterprise writ large–and so it will use "natural values" for its resource allocation decisions. Thus (*NV*, p. 228),

> [a]n exact economic calculus must be established, the advantage and disadvantage of every sufficiently familiar process being put in figures; and it must be regarded as the triumph of economic art to exactly ascertain and exactly realise that plan which the value calculation indicates as the best.

It has previously been shown that Wieser fatally confuses subjective use value (marginal utility) with objective exchange value (price) in attempting to provide a foundation for calculation under socialism or communism. This confusion, as well as his methodological departure from considering marginal value calculations to be individual and subjective, introduces an ambiguity into the meaning of subjective value that empties his concept of "natural value" of any coherent content. This is true whether one uses the term "natural value" or "marginal utility" to refer to those marginal values. In this regard, it matters not that (*NV*, p. 242) Wieser refers to "natural value" as an "unempirical" fiction used in a work intended to be "in the best sense of the word, empirical." A fiction that has no definable content has no comprehensible use. Thus, without a precise conception of "natural value," the basis for "valuation according to natural value" is missing. And, if valuation according to natural value is incoherent, the expression of natural values in the form of exchange values is impossible–even if equal prices for similar goods were taken as expressions of equivalences in (subjective) value of those goods.[31]

In short, "natural values" cannot be used for resource allocation by public enterprises or the communist state if they remain unexplained and thus

[31] As, for example, in Jevons (1871), Chapter IV.

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unidentifiable. It cannot even be imagined what part they might play in resource allocation if they remain, as Wieser leaves them, a sort of economic phlogiston. Yet, Wieser carries a "short-hand" version of them beyond *Natural Value* into his monumental *Social Economics*, which becomes the primary reason his argument fails.

Natural Value and the Theory of the "Simple Economy"

Summary of the Theory

In his *Principles*, Carl Menger seeks to explain the principles of economic calculation in the face of scarcity for two spheres of human action. The first is that of the individual or "isolated household economy." Within this sphere Menger explains the source, nature and measure of economic value, and the imputation of value from "first order," or consumption, to "higher order," or intermediate, goods. The second sphere is that of the exchange or "social economy." This is a complex of household economies that engage in voluntary production and trading activities so that each might better achieve individual economic goals than would be possible if each sought to achieve them in isolation. In that context, Menger explains the principles of exchange and of price formation under various market orders.

The first two books in Friedrich von Wieser's *Social Economics* (1967) follow the same subject order; however, both the method and content of his explanations are far different from those of Menger. Rather than an "isolated household economy," Wieser posits an omniscient, totally rational planner of an entire nation as his economic subject in his "simple economy." In this respect, his "simple economy" is a formalization of the public enterprise writ large or "communist state" of Book VI of *Natural Value*. Further, in his own theory of the "social economy," in addition to an explanation of the principles of voluntary exchange and price formation under various market orders, Wieser attempts to draw the implications of the inequality of wealth and talents for social conflict. Even further, he argues that the principles of explanation provided by the marginal utility theory for both simple and social economies are equally applicable to the socialist economy. In fact, claims Wieser (*SE*, p. xx), the marginal utility theory "gives the most effective weapons to the socialistic critic" of the exchange economy.

Wieser's theory of a "simple economy" begins with an extended discussion of human needs, for the satisfaction of which the omniscient manager directs the production of goods. Each household is assumed (*SE*, p. 21) to require a specific quantity of goods and services (its "demand") to meet these needs. But, this is not a growing economy; it is (*SE*, p. 43) one in "a static condition which has reached an equilibrium" of "a given, habitual state of economic efficiency." Gossen's "law of the satiety of needs" is invoked (*SE*, pp. 25-34) to produce the law of diminishing marginal utility in consumption, coupled with an arbitrary categorization of needs into "vital" and "pleasurable." The latter

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category is capable of abuse and transformation into "the degenerative needs of luxurious desire," but only by the wealthy in an exchange economy. In the "simple economy," the omniscient, totally rational manager will only (*SE*, pp. 34-35) provide for the "well-being" of consumers; and, (*SE*, p. 22) apparently can calculate the exact marginal utility obtained in the application of each unit of each commodity to the satisfaction of each consumer's every need—both in the present and (*SE*, pp. 36-39) at each point in the future. All members of the economy's households are assumed (*SE*, p. 20) to be totally compliant and obedient to the manager's wishes. Further, production is directed at meeting their "demand," that is, (*SE*, p. 45) "it is the task of production to furnish the 'household' with those goods which are lacking at any time."

In this ideal, static, perfectly managed economy, the omniscient manager seeks (*SE*, p. 46) the maximum total utility. His means is (*SE*, pp. 48-50) the technical organization of production and distribution in such a way that (*SE*, p. 51) no productive resource can be shifted from one use to another without a diminution in the total utility of the consumption of output. This would occur if the marginal utility lost in consumption of the good whose output is reduced is greater than the marginal utility gained in consumption of the good whose output is increased as a result of the resource shift. In contrast to the exchange economy, which Wieser says (*SE*, p. 49) is unified by "the connecting medium, money," the simple economy is unified on the production side by "the labor of the producer." Thus, it is the allocation of labor in production that is the key to the maximizing of total utility in the simple economy.

Turning to the question of the organization of production, Wieser discusses in turn, labor, capital, and land. With respect to labor, he argues that (*SE*, p. 59) when labor is scarce it is applied according to the expected utility of its product, rather than conferring value on its product in proportion to the labor exerted in its production, as the labor theory of value would have it. With respect to capital, he begins by restricting his discussion to physical capital goods, the (*SE*, p. 63) so-called "produced means of production," that are (*SE*, p. 65) individually consumable in the process of production, but, by being constantly productively replaced, are not consumable as a totality. This "natural economic capital" he views as an aggregate capable of being "concentrated under one embracing control" in the theoretical "simple economy," just as it would in a socialist economy. With respect to land, he follows the Ricardian argument on the expansion and increased intensity of cultivation with population.

Wieser's conception of production in the "simple economy" by means of labor, capital, and land is a purely physical one. The (*SE*, p. 81) "natural costs" of production are the amounts of labor, capital, and land that are used to obtain specific amounts of specific outputs. These "cost-productive-means," through their various productive relationships, are said to provide a unity to all branches of production and neither include inputs with unique characteristics nor the actions of the entrepreneur—both of which Wieser terms "specific productive means." Following a brief explanation of the law of marginal

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utility, he argues (*SE*, pp. 96-97) that a given amount of productive inputs should be allocated among known possible uses in production so that the marginal outputs of all commodities produced yield approximately equal marginal utilities in consumption. Alternatively, the principle is (*SE*, pp. 100-03) to produce so as to minimize the opportunity costs of output actually produced—where opportunity costs are the marginal utilities of output possible but not produced with the given inputs.

Because of the complementary nature of productive inputs, this introduces the problem of imputation, which Wieser (*SE*, p. 113) now recognizes as a different problem from that of distribution. He sees the former as concerned with the organization of production, while the latter is a question of property rights. Thus, even under socialism he believes that the (*SE*, p. 116) "practical" problem of imputation must be solved. A critique of Menger's argument, similar to that found in *Natural Value* (discussed in Section 4 above) but more vague and just as misrepresentative, is then followed by Wieser's own attempt at explanation. He prefaces that explanation with the claim (*SE*, p. 119) that "the entire yield realized as expected under the scheme of operations must be attributed without a remainder in the measure of the productive contribution." Unfortunately, and perhaps (*SE*, p. 123) as one result of Böhm-Bawerk's (1959, III, pp. 80-95) criticisms of his approach in *Natural Value*, Wieser merely recommends the method of determination by simultaneous equations, without an attempted specific demonstration. Rather than the "total value of the return," the inputs are now somehow to be arithmetically related to the marginal utilities of their marginal products. Other than vague references (*SE*, p. 120) to "trial and error" and (*SE*, p. 126) to an indifference equation of utility values among various commodities, how this is to be done is left as an open question.

As it turns out (*SE*, pp. 124-27), it is the assumed ability to compute marginal utilities that is the key to Wieser's proposed solution for the organization of production and consumption in the static "simple economy," or "model social economy" as he now (*SE*, p. 134) refers to it. All inputs and outputs are to be reduced to (*SE*, p. 126) sums of "units of utility" to form "the arithmetic foundation for a plan of production and management," for these are (*SE*, p. 135) the economy's "natural values."[32] If each input and output can be stated as equivalent to so many units of utility, then all can be compared for planning purposes. The overall plan will provide all commodities to meet consumer needs at the minimum utility cost and thus maximize total social utility.

[32]This is the first use of the term in *Social Economics*. Presumably, Wieser now thinks of natural value as simply the value of a thing expressed as so many units of utility, somehow determined. But, see (*SE*, p. 169), where the term is used to refer to the commodities exchanged in a barter system.

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In particular, physical capital, and its gross yield in specific production processes, would be reducible (*SE*, pp. 133-38) to so many utility units, and the ratio of the net yield to capital consumed could be calculated to determine the real rate of interest or marginal productivity in each possible use. This would be necessary for, and thus enable, rational capital allocation.

Wieser closes his treatment of the "simple economy" with (*SE*, p. 144) a claim similar to the one he made in the last chapter of Book V of *Natural Value*:

> All rules of the computation of utility value which we have deduced in the theory of the simple economy are observed in the computation of exchange value as it is universally practiced. Whenever we disregard the stress of economic power we shall find that the utility value of the simple economy is precisely the same economic value which functions in the transactions of economic exchange. To this extent, then, every economy in computing according to value in exchange complies with the original aims of economy.

Critique

Two approaches to a critique of Wieser's theory of the "simple economy" suggest themselves. The first is to treat the "simple economy" as equivalent to the "isolated household economy" of Menger and to examine its internal consistency and then compatibility with Mengerian marginal utility theory. Wieser specifically (*SE*, p. 19) denies such an equivalence, although he refers (*SE*, p. 87) to "the economy of a Crusoe or of the free, socialistic state of the future" when presenting the marginal utility theory of value.

The other approach is to take Wieser literally and critically examine his mental creation, again for internal consistency and compatibility with Mengerian marginal utility theory. As it turns out, only if the "simple economy" is treated as an isolated household or Robinson Crusoe economy can some degree of such consistency and compatibility be achieved. Any attempt to treat the "simple economy" as in some sense a social economy results in the loss of the basic building blocks of marginal utility theory—marginal utilities themselves.[33] And, because these are what Wieser now refers to as "natural values," his theory of allocation under socialism and later critique of the exchange economy both fail through their basic incoherence.

As Wieser presents it, his "simple economy" is a magician's black box. On one side of the box are households, who are presumed to have given sets of "needs" that can be satisfied by means of specific amounts of specific commodities. On the other side of the box are land, labor, and physical capital

[33]Schumpeter (1954, pp. 915-16) asserts that Menger and Wieser almost solved the problem of showing how imputation is not confined to Crusoe's use of it in valuing and allocating resources, but extends to the pricing of factors in the context of free market exchanges—presumably, its only uses. But see footnote 12 above.

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goods that can be combined to produce the commodities. Within the box are the actual production processes that transform inputs into outputs. The orchestrator of the entire process is the omniscient manager, dedicated to maximizing the total utility of the population. His method is a purely physical transformation, by his completely compliant subject people, of given amounts of inputs into outputs to meet consumer "demand" so that opportunity costs measured in utility units are minimized for all production processes.

First, it is difficult to see why this way of conceptualizing a solution to the problem of scarcity is not simply a restatement of Robinson Crusoe's situation, before the arrival of Friday. Wieser claims (*SE*, p. 49) that his simple economy is unified on the production side by "the labor of the producer," in contrast to the monetary unification of the exchange economy. That is Crusoe's position. He has only his labor as the directing, organizing and acting force that transforms the resources of his island into goods capable of satisfying his needs, to the extent desirable and possible. Nothing substantive is added by assuming more people and an omniscient manager, who manipulates them like pawns on a chessboard. In fact, something is lost–the independence and originality of Crusoe's choice of goals and of the methods of their attainment, given his resources.

Second, the problem faced by Crusoe is a scarcity of means to meet his various–and unlimited–ends. It is not one of transforming given amounts of resources to satisfy a given set of needs. Wieser is inconsistent. Either (*SE*, p. 21) specific quantities of goods and services are to be produced to meet consumer "needs," using whatever resources are available, or (*SE*, pp. 96-97) there are given amounts of productive inputs to be used in such a way that they produce outputs that confer the greatest amount of total utility.

Third, Crusoe's story is one of growth, a dynamic process of trying to move beyond mere survival to prosperity and, eventually, escape from the island. The static allocation model envisioned by Wieser is inadequate even to the task of explaining Crusoe's economy. And, whether confined to the Crusoe dilemma or not, a static allocation model drops Menger's context (*Principles*, 1976, pp. 67-71) of production as a process set in real time involving foresight, tempered by uncertainty. As Mises would later argue with respect to economic calculation (1951, p. 139), it is "a problem which arises in an economy which is perpetually subject to change, an economy which every day is confronted with new problems which have to be solved." Thus, how Crusoe transforms resources into goods that will meet his needs is also dynamic. It depends on his time horizon, his knowledge and creativity, his ultimate ends, the resources at his disposal or later discovered or lost, and other factors not under his control, such as the weather or the appearance of Friday or of pirates or cannibals. Finally, if he has a high expectation of ending his days on the island, this implies a completely different set of priorities than if he is dedicated to escaping.

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Fourth, if Wieser is taken at his word and his "simple economy" is to be taken as a model for socialism then, as in *Natural Value*, human beings drop out of the model. Subjective marginal utilities are to be made objective data through the device of the omniscient manager of the economy. What purpose does this fantasy serve? No principle for the direction of a socialist economy can be derived from a situation that is impossible in any economy of actual human beings. Imagining that the knowledge of subjective marginal utilities would make it possible for state planners to rationalize production does not provide that knowledge. Nor does it provide any principles for using marginal utilities as they actually exist–as subjective evaluations–to rationalize production. Further, as Mises (1935, pp. 96-97) and (1951, pp. 114-15) points out, no "unit of value" is assumed in individual subjective judgments of value, merely a ranking for planning purposes.

Fifth, the concept of production as a static, purely physical process of transforming labor, land, and physical capital into physical goods is a regression to a pre-Mengerian view of the solution to the economic problem of scarcity. The concern with achieving the maximum total utility in distribution of the physical goods, or in minimizing the opportunity costs of production in utility terms, ignores the active force of consumer-driven entrepreneurship. It is that active element, combined with expanding knowledge and increasing control over production conditions, that forms, drives, and improves the process of transforming higher order into lower order goods in the Mengerian conception (1976, pp. 71-74) of economic progress.

Finally, Wieser's attempt (*SE*, p. 144) to claim an equivalence between computing utility values and computing exchange values in an economy without "the stress of economic power" repeats the error of *Natural Value* (p. 213) of discarding the foundational rationale for the exchange economy, as was also previously discussed.[34]

Conclusion

Friedrich von Wieser concludes *Natural Value* with the statement (p. 242) that the intention that "dominated" him throughout the work was "to be, in the best sense of the word, empirical," although he admits to have used "the fiction . . . of a natural value and of the utopian state of communism."[35] Then, he begins *Social Economics* with (pp. xvii-xxi) the claim that the theory of marginal utility provides the means for "enlightened statesmanship" to manage the social economy, a means which both classical and socialist theory

[34]Wieser nevertheless is aware (*SE*, pp. 167-68) of the inequality in marginal utilities that provides the incentive for exchange.

[35]For an argument that what Wieser actually did was to construct a normative theory of "economic activity as it logically ought to be" see Mitchell (1950, pp. 247-57).

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failed to provide. At the same time, he asserts his belief that the task of marginal utility theory is to provide a new foundation for socialism.

This paper has argued that the "fiction" of "natural value" is an empty concept that fails to serve the purpose of its author and undermines, rather than supports, his argument. Further, it has argued that marginal utility theory as developed by Wieser is neither a means for political economic management nor a replacement for the labor theory of value as the foundation of socialism.

If there is no "natural value" beyond the subjective marginal utility attributed to a unit of a good by an individual, and if knowledge of this subjective marginal utility is confined to the individual, and if the theory of exchange is not altered by income or wealth assumptions, then Wieser did not develop the theories of value, exchange, and price beyond the legacy of Carl Menger. In fact, he distorted and obscured them in his own presentation with his empty concept of "natural value," his spurious analysis of exchange value in contrast to "natural value" and his equally spurious imputation theory. Further, he provided an apparent theoretical support for socialist and communist theory from a school of thought whose previous and subsequent development (at least in the hands of Menger, Böhm-Bawerk, and Mises) was antithetical to such theories.

The historical record suggests that Hayek would not only have disagreed with the above evaluation of what Wieser did with the Mengerian legacy, but would have strongly disagreed.

In his 1926 article on the problem of imputation, he clearly argues for Wieser's version over that of Menger and Böhm-Bawerk, and does so after asserting (Hayek 1984, p. 34) that it is "knowledge of the determinants of income which constituted the objective of theoretical economics . . . [c]onsequently, the whole of economic theory rests on the explanation of the value of producer goods and thus on the theory of imputation." Further, Hayek explicitly adopts Wieser's "simple economy" as the context for his argument and argues (p. 46) not only the primacy of Wieser's approach over that of J.B. Clark and other advocates of the marginal productivity theory, but (p. 47) the advantage of the "simple economy" assumption even for the application of the marginal productivity approach.

In his laudatory obituary for Wieser, also in 1926, Hayek (1992c, p. 114) specifically credits Wieser with extending Menger's subjective value theory "to the laws governing the structure of production" and "the laws of income distribution," by means of "the concept of marginal utility, its application to production goods, costs as indirect utility, and imputation of value." Wieser is able to accomplish this explanation of (p. 116) "the more complicated situations in a society's economy . . . [without] falling into the dangerous trap of using the phenomena of an exchange economy as the basis of its explanation." In particular, Hayek credits (p. 121) Wieser's "simple economy" section of *Social Economics* with the detailed explanation of the "structure of production."

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Eight years later, in his introduction (1992b, pp. 70-71) to the London School of Economics edition of Menger's collected works, Hayek refers to that same section of *Social Economics* as the "clearest systematic expression" of "the technical structure of production" by "the Austrian school." In fact, for at least a quarter of a century, according to Hayek (1992b, pp. 136-37), after he worked under Mises in an Austrian government office and became familiar with Mises's arguments, Hayek not only lauded Wieser's contributions to economic theory, but also used (Salerno 1999, 2002) a general equilibrium context for much of his own theoretical work. As was mentioned in the introduction to the present paper, Hayek explicitly adopted (1975, p. 27, n. 1 and p. 156, n. 1) Wieser's "simple economy" context for the initial theoretical part of his own 1941 *Pure Theory of Capital*–thus reproducing the structure of Wieser's *Social Economics* for presenting Hayek's own capital theory. Imitation is always the sincerest form of flattery.

During the same quarter of a century, Mises pursued a radically different course of thinking and research. Mises's "Economic Calculation in the Socialist Commonwealth" was published in 1920, soon to be followed in 1922 by *Socialism*. It is not difficult to identify arguments directed against Wieser's enterprise in those two works, as well as in Mises's *Nationalökonomie* in 1940 and *Human Action* in 1949–although Wieser is only critically referenced in the later works.

Hayek (1992b, p. 137) read *Socialism* soon after its publication and (p. 139) joined Mises's seminar in 1924. It seems particularly relevant to point out that as late as 1978, Hayek could still write (p. 141) that "many of its arguments, which I initially had only half accepted or regarded as exaggerated and one-sided, have since proved remarkably true [although] I still do not agree with all of it, nor do I believe that Mises would." In light of the argument presented in the present paper, it is difficult to avoid the speculation that the main argument that Hayek either half accepted or regarded as exaggerated and one-sided–at least until 1945–was, in fact, the argument that economic calculation is not possible under socialism because, either theoretically or practically, socialism has no means for placing values on higher order goods. If so, then Hayek's emphasis on the knowledge problem of socialist planning reflected his conviction that it, not calculation, was the dominant obstacle to rational economic choices under socialism.

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THE VIENNESE CONNECTION: ALFRED SCHUTZ AND THE AUSTRIAN SCHOOL

PETER KURRILD-KLITGAARD

> [M]y scanty knowledge of economics is based on what I learned in Vienna some 25 years ago as economic theory and this was based on the particular brand of marginal theory developed by the Austrian school.
>
> –Alfred Schutz, Letter to Adolph Loewe, 7 December 1955[1]

To what extent is it necessary to understand the intellectual climate in which ideas are formulated in order to understand the ideas themselves? This question, no doubt one of the most fundamental–and controversial–in the study of intellectual history, is no less relevant when it comes to the study of one of the founders of interpretive sociology, the Austrian-American philosopher and sociologist Alfred Schutz (1899-1959).[2] Schutz is widely recognized among sociologists and philosophers as having attempted a highly original and complex synthesis between the interpretive philosophy

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[1]In the Schutz papers, Beinecke Library, Yale University.

[2]Schutz's most important works are *The Phenomenology of the Social World* (1967) and the essays assembled in the *Collected Papers of Alfred Schutz*, Vol. I-IV (1962, 1964, 1966, 1996a). Schutz originally used the Austrian spelling *Schütz* but Anglicized the spelling. This was also done by many other German and Austrian immigrants to the U.S.,

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of Max Weber, the phenomenology of Edmund Husserl and elements of the thought of Henri Bergson and William James, and he is indeed one of the most influential sociologists of the twentieth century. This alone should interest sociologists in what "sparked" Schutz's work. But even more so should the fact that his stated purpose in such a synthesis was to provide a unified foundation for an objective social science based in the actions of individual agents within the subjective common-sense-experienced reality of the everyday life-world. In that respect Schutz was truly remarkable among sociologists of his time.

This should, quite naturally, also raise some interest among those with an interest in the methodology of economics, and so should the fact that Schutz in his youth studied in Vienna and was associated with a number of the members of the third and fourth generations of the Austrian School of economists, in particular with Ludwig von Mises (1881-1973), Friedrich August von Hayek (1899-1992), and Fritz Machlup (1902-1983).[3]

However, until recent years Schutz has been relatively unknown outside the circles of phenomenologists, sociologists, and ethnomethodologists. It would seem natural for both sociologists and economists, notably those of a methodological individualist and subjectivist orientation, to consider whether Schutz was actually influenced by the Austrians, and if so, to what extent.

It might also raise the no less interesting questions of whether what Schutz had to say for sociology in any way may have influenced any of his Austrian contemporaries, or conceivably could be of any use for contemporary economists.

There would seem to be several good reasons for taking a closer look at the intellectual and personal connections between Schutz and the Austrians. There is some disagreement on the question of the *extent* of Schutz's personal and intellectual affiliation with the Austrian economists. One interpretation, which has been dominant, especially among sociologists, sees Schutz as only peripherally associated, while another, which has emerged in recent years, sees the connection as much closer.

The purpose of the present paper is to take a closer look at that question, and to offer evidence in support of the latter proposition. The primary focus will be upon contributing to the understanding of the historical setting in

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e.g., Steffy Browne (Braun); Walter Froelich (Frölich); Herbert Furth (Fürth); Erich Voegelin (Vögelin); and Adolph Lowe (Löwe).

[3]Carl Menger founded the Austrian School while the second generation of the school consisted of his collaborators, Friedrich von Wieser and Eugen von Böhm-Bawerk. The third generation consisted first and foremost of Ludwig von Mises and in some respects Joseph Schumpeter and Hans Mayer. With the fourth generation the territorial designation became an intellectual rather than a geographical designation; this generation was primarily the Austrian and American students of Mises, notably Friedrich August von Hayek, Murray N. Rothbard, and Israel Kirzner. For a short introduction to this "genealogy" of the school, see White (1984). See also Grassl and Smith (1986) and B. Smith (1990, 1994).

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which Schutz became acquainted with the Austrians; as such it will deal less with the character of the theoretical affinities and influences themselves, which I have examined elsewhere (Kurrild-Klitgaard 2001). I shall approach the issue on the assumption that if we can establish that the personal relationship was closer than usually assumed, we may be better equipped to address the question of the intellectual nature of the relationship. In the following I shall accordingly try, first, to briefly introduce the two interpretations of Schutz's relationship with the Austrians, and second, to cast new and more detailed light upon some aspects of the relationship and to do so by drawing upon a large number of previously unknown or neglected materials,[4] which may seriously challenge the standard picture of Schutz's relation to the Austrians. Having done so, I shall offer some conjectures for why this redrawn picture of the personal relationship may enlighten our understanding of the intellectual relationship.

Two Stories of Schutz and the Austrian School

The usual picture of the relationship between Alfred Schutz and the Austrian economists seems to be that their only commonality was that they were Austrians, social scientists of more or less the same generation, and of the same social circles. As such the relationship has until recently received little attention among economists, and to the extent that the relationship is mentioned at all in the sociological literature on Schutz, the focus is typically more on what separates them, than on what unites them. It is continuously pointed out that Schutz did not share the methodological orthodoxy, classical liberalism, and individualism characteristic of most of the Austrian economists; rather Schutz is seen as an original thinker, who nonetheless managed to stay within the "sound mainstream" of sociology.[5]

Wagner's Story

This is, at least implicitly, the view of Schutz's foremost "intellectual biographer," the sociologist Helmut Wagner (1983). Wagner's premise is that a

[4]These include: (1) Schutz's private papers and correspondence (Beinecke Library, Yale University); (2) Schutz's unpublished recollections of Mises in an interview conducted by Bettina Bien Greaves on 20 November 1958 (Foundation for Economic Education); (3) Ilse Schutz's unpublished memoirs (Beinecke Library); (4) Wagner's original 2,600 page manuscript for his biography of Schutz (Beinecke Library); (5) Machlup's; (6) Mises's (Grove City College); (7) Hayek's and; (8) Voegelin's private papers and correspondence (Hoover Institution, Stanford University); as well as (9) Gottfried Haberler's and J. Herbert Furth's unpublished recollections in an interview with the present author on 26 June 1993 (author's collection).

[5]This interpretation is somewhat akin to one found among some contemporary Austrian economists. Here Schutz is seen as someone who, though personally and to some extent intellectually associated with the leading Austrians, was basically outside the school.

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full understanding of Schutz's complex theoretical work presupposes an understanding of his personal and intellectual development and the sources which influenced him. He even stated that Schutz's "close friendships" were "closely interwoven with the story of his intellectual life. . . . It was . . . essentially within the spheres of his [co-students and] age peers that Schutz found the hints and challenges that he needed in order to find out where to look for what he was looking for" (Wagner 1983, pp. 10-11). Yet for whatever its other qualities Wagner's intellectual biography is one of the most consistently neglectful works among sociologists of the connection between Schutz and the Austrian economists, and accordingly of any possible influence.[6] For given his premises it is particularly difficult to understand the treatment of the Austrian School. Wagner does not deny that there was a personal connection between Schutz and the Austrians, and he does identify some aspects of the relationship.[7] Yet his voluminous and otherwise exhaustive biography contains only a little more than a handful of references to Mises and even less to Hayek (though some to Machlup), and when references are made, they are more often in the form of distancing Schutz from the Austrians than in considering their possible affinity.[8]

Some indeed view Schutz as having been influenced in a positivist and occasionally historicist direction by his close friend, Felix Kaufmann. Cf., e.g., Selgin (1990, pp. 20-27).

[6]Another example is Grathoff's (1978) prominent, 29 page essay on Schutz, which devotes a total of two sentences to the Austrian School–containing one minor and two major factual errors. Other illustrative examples–though without any factual errors–are the papers collected in the "Schutz Special Issue" of the scholarly journal *Human Studies* (1984, vol. 7, no. 2), which running more than 140 pages contains not a single reference to any of the Austrian economists (though some to Kaufmann). This is particularly surprising for Wagner's (1984) and Helling's (1984) contributions to that very volume, considering the subjects of their respective essays.

[7]Wagner does, e.g., note, that some of Schutz's teachers "not only fostered his future professional competence but accelerated his intellectual-avocational development" and here mentions Mises as a permanent influence (Wagner 1983, p. 11). He also notes that Schutz was "personally very close to von Mises" (p. 13). But apart from these two brief statements Wagner offers no examples of how this might have influenced Schutz's thinking. Rather–to the extent he mentions the connection at all–Wagner repeatedly focuses on perceived differences and neglects possible similarities.

[8]See, e.g., Wagner (1983, p. 13), where he, no doubt due to a lack of understanding of Mises's theorizing, distances Schutz's view of the unity of the social sciences from that of Mises's. Wagner also misses Mises's continuous stress of the importance of the *wertfreiheit* of the social sciences, when he writes that though Schutz "accepted marginal utility theory in principle" he, "in contrast to von Hayek and in agreement with many other students of von Mises . . . did not subscribe to the extreme economic liberalism of his teacher" (p. 12). Also, two things should be noted about the liberalism of the Austrian economists. First, while it is no doubt the case that many twentieth century Austrian economists were classical liberals, this can hardly be seen as a necessary characteristic of the school. Second, it is simultaneously true that while few of Mises's students–including Hayek–shared his particular brand of liberalism, they were all liberals of some form. Finally, Wagner in general stresses the differences between Mises and Schutz, rather than

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Anticipating the evidence to be considered here one might say that Wagner was consistently downplaying the character and importance of Schutz's possible relationship with the Austrians. But in doing so he runs the risk of either missing or misrepresenting personal relationships that may have been important for Schutz's intellectual development. Wagner, in fact, neglects or misrepresents a large number of points that will be stressed here; his total assessment of Schutz's possible affinity with the Austrian economists is encapsulated in this short passage: "Schutz accepted marginal utility theory in principle. . . . What *kept* him within the Viennese school were its underlying interpretative assumptions: it explained an apparently mechanical and impersonal economic process in terms of subjective decisions and individual actions" (Wagner 1983, p. 12; italics added). Beyond this Wagner totally neglects the important *Methodenstreit*, which so completely formed the basis of the debate among Viennese social scientists of the 1920s and the background of Schutz's studies, or any treatment of how the Austrians in this respect differed from, e.g., the Historicists and the Positivists. Wagner also fails to mention that it was Mises who encouraged Schutz to pursue the study of Max Weber's thought, which sparked the course of further pursuit. Indeed, in his schematic representation of the major phases of Schutz's intellectual development, Wagner does not mention the connection to the Austrian economists at all. Among the important personal points missed are that Schutz's relationship with Machlup, Hayek, and Mises went back to his days as a student, and that it was Mises who got Schutz his first job. Wagner (p. 166), for example, erroneously reports that Schutz and Machlup first knew each other from 1924, and that while Schutz "spoke highly of Hayek" he "was not a personal friend of his" (p. 158).[9]

All this seems odd *a posteriori* when the facts to be presented are considered, but it seems particularly odd given Wagner's own stress of the intellectual importance of Schutz's personal relationships. Wagner's neglect of the Viennese connection could perhaps have been attributed to ignorance—had that been possible. But it is so much more inexcusable due to the fact that Wagner, during his many years of writing the intellectual biography, had access to more or less the same sources as those consulted here.[10] In my view,

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the similarities, in his references to the latter's views on economics; see Wagner (1983, pp. 12, 52, 168).

[9]Among the minor, yet highly indicative, omissions made by Wagner is that he did not include Schutz's review of Mises's 1933 book (Schutz 1996b) in his Schutz bibliography (Wagner 1983, pp. 339-45)—the only time Schutz publicly addressed economics and the Austrian School explicitly. Neither does he have any references to any of the works by Mises or Hayek. Wagner (1983, p. 52) also mistakenly reports that Mises stayed in Vienna until 1938 and incorrectly gives the title and year of Mises's *Grundprobleme der Nationalökonomie* (1981) as *Grundlagen der National Ökonomie* in 1934.

[10]Furthermore, among the more than two dozen friends and collaborators of Schutz's credited for having helped Wagner with personal information (Wagner 1983, p. ix), only

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it can only be attributed to a preoccupation with what interested him the most, and a failure to understand the similarities between Schutz's project and that of, e.g., Mises and Hayek. This again was due to a lack of knowledge of the historical-intellectual setting and themes of the Austrian School.[11]

A New View

In recent years an emerging, "revisionist" interpretation of the relationship between Schutz and the Austrians has both challenged and weakened the standard interpretation. Here Schutz is seen as both personally and intellectually closer to the Austrians than claimed by others, and indeed as taking his cue from the Austrians, especially Mises, to such an extent that he perhaps may even be said to belong to the Austrian School, albeit on the fringes. Furthermore, such a perspective also opens up the door for the interesting question of how Schutz possibly could have influenced the Austrian economists.

Austrian economists and historians of thought have, of course, long been aware that Schutz in his youth had been associated with the Austrian economists.[12] Yet the interest among economists in the work of Schutz was probably initially sparked by the Austrian economists Murray Rothbard and Ludwig Lachmann, who pointed towards how Schutz's common-sense-realism and emphasis upon purposive human action had a fundamental affinity with elements of the Austrian program.[13] Subsequently, a number of Austrian economists have emphasized how Schutz's thinking is deeply indebted to some of the same sources and may be seen as fundamentally compatible with and even complementary to Austrian economics.[14] A similar turn has occurred among sociologists, who not only have rediscovered Schutz's historical affiliation with the Austrian School, but also have gone on to identify theoretical areas of commonality and difference between them, as well as how

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one—Machlup—belonged to the Austrian School. None of the Austrians alive when the book was written, who might have provided personal information, e.g., Hayek, Haberler, Furth, and Margit von Mises, are credited—despite the fact that Wagner actually consulted several of these and received information from them!

[11]The excuse could have been the vast amount of material used by Wagner and the need to cut the manuscript; the original draft was 2,600 pages.

[12]See, e.g., the memoirs and other writings by Mises (1978) and his wife (1984); as well as Hayek (1994); Machlup (1974, 1982); and Haberler (1974, 1981).

[13]Rothbard (1973, 1976) was among the first to draw attention to the intellectual and personal connection between Schutz and the Austrians. While retaining a favorable view of Schutz's possible affinity with the Austrians on some points, Rothbard (1989, 1990) also warned Austrian economists against the historicism and nihilism present in some phenomenological and hermeneutical thinking. Lachmann on several occasions pointed to the similarities between the Austrian economists and Schutz in, e.g., his *The Legacy of Max Weber* (1970). Cf. Lachmann (1982) and Caldwell (1992, pp. 140-42).

[14]See, e.g., O'Driscoll and Rizzo (1985); Boettke, Horwitz, and Prychitko (1986); Ebeling (1986, 1987a, 1987b, 1987c); O'Sullivan (1987); T. Alexander Smith (1988); Langlois and Koppl (1991); and Koppl (1997, 1998).

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Schutz may be seen as having tried to build a bridge between sociology and economics.[15]

This first such revisionist interpretation of Schutz's relationship to the Austrian School was the detailed work of the sociologist Christopher Prendergast (1986). According to Prendergast, Schutz's aim was not to reform only sociology, but economics as well; Schutz saw his synthesis of Husserl and Weber as a means to answer the much more important question of what the proper foundations of a methodology of human action, applicable to *all* of the social sciences should be:

> In his reconstruction of the ideal type, Schutz promised to reconcile history, the most humanistic social science, with economics, the most nomothetic. Looking beyond Max Weber, who saw sociology as a generalizing auxiliary discipline to economics as well, provided that a common methodology and a common corpus of concepts united the three fields. No longer operating in isolation or competition, each discipline would become progressively more "objective," in the sense of utilizing the smallest number of concepts recognized as relevant to their respective subject matters. (Prendergast 1986, p. 1)

Prendergast's point is that Schutz's interests and works were sparked and shaped by the methodological debates which took place within the Austrian School in the 1920s. He sees Schutz as having been motivated by dissatisfaction with Mises's account of intersubjective understanding and with his proposed justification of the validity of the propositions of economic theory. Yet, according to Prendergast, this critique was not sparked by hostility; rather Schutz was "[c]ommitted to the school's overall methodological standpoint, but recognizing inadequately justified components . . . began to investigate alternative solutions" (p. 3). Schutz "never questioned the core elements of the Austrian tradition. His efforts were consciously oriented towards its preservation, although the rescue required that it be set upon different epistemological pilings" (p. 4).

The interesting point is that Prendergast's work in reality is very speculative and hypothetical, albeit qualified and insightful in its challenges. The time of publication could in a sense hardly have been worse considering that within a relatively short time the literature on the subject would blossom, partly due to new historical research and partly due to new interpretations by some Austrian economists of the roots of their own school.[16] Furthermore,

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[15]The frontrunners probably were Kauder (1965) and the prominent Schutz scholar, Maurice Natanson, who originally commissioned Rothbard's 1973 article and has argued that Mises and Schutz supplement each other, cf. Bradley (1979, p. 4). See also, Helling (1984, 1988); Prendergast (1986, 1993); Eberle (1988); as well as several writings by Srubar (e.g., 1993); and Esser (1993a, 1993b).

[16]See especially Craver (1986); Ebeling (1987c); Eberle (1988); and Helling (1988).

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Prendergast relies heavily–although innovatively so–on the information supplied by Wagner's rather selective portrait and did not have access to, or utilize a number of, the sources which could have been consulted, and which might have supported the biographical aspects of his theory even better. The purpose here is to consult some of these sources in order to supplement the picture of the "Viennese connection" between Schutz and the Austrians.

The Personal Connection

Alfred Schutz had–just like many of the Austrian economists–attended a *gymnasium* with a strong emphasis on the Classics. In 1917, he graduated *summa cum laude* and after having been drafted and served a year and a half in the collapsing Austro-Hungarian Imperial Army he returned to Vienna in October 1918.

The Vienna in which the young Schutz found himself was one full of contradictions. On the one hand it was the depressed capital of a former world power, the mighty Austro-Hungarian empire, now almost decimated in prosperity, territory and importance, and plagued by hyperinflation. On the other hand, it was also a sparkling intellectual environment, about to enter into one of the most creative and fascinating periods of European intellectual history. It was a city dominated by art and academia, as well as coffeehouses where students daily could meet, discuss and drink with some of the intellectual giants of the century–where one could literally observe thinkers like Weber and Schumpeter shouting angrily at each other.[17]

But academically Vienna was, first and foremost, the home of a number of important intellectual circles, which in the aftermath of the *Methodenstreit* between the Austrian economists and the German historicists functioned as centers for important debates on methodology, philosophy of science, economics, and social policy, and usually were centered around one or a few prominent figures. No doubt, the best known of these was the logical positivist *Wiener Kreis*, the Vienna Circle, centered around the philosopher Moritz Schlick, and including, among others, Rudolph Carnap, Kurt Gödel, Karl Menger, and Otto Neurath. Other prominent circles were the groups centered around the economist Othmar Spann and the jurist Hans Kelsen, while others were the so-called *Sozialkatholiken*, centered around Ignaz Seipel, and the *Austro-Marxisten*, headed by Otto Bauer. Yet, according to many accounts, the most influential of circles was the group of Austrian economists, often known simply as the *Miseskreis*, centered around the *Privatseminar* founded and conducted by Ludwig von Mises.[18]

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[17]For the amusing account of this incident, see Somary (1986, pp. 120-21). On the coffeehouses, see also Hayek (1994, pp. 55-56).

[18]According to Voegelin, who was not only a regular of the *Miseskreis* but also participated in the circles organized by Spann and Kelsen, the well-known *Wiener Kreis* was in the 1920s considered as more a fringe group than as a leading philosophical group, cf.

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The Background: Vienna ca. 1920

It was just around the time when these intellectual circles began to blossom that the young Schutz entered the University and came in contact with Mises–an event which probably changed the course of Schutz's intellectual life and affected the personal lives of both. Schutz had originally wanted to become either a physician or an orchestra conductor, but a partial impairment of his hearing made both careers impossible. Instead his mother suggested that he study law, which would open up a number of career possibilities; at that time the law-study in Austria (and Germany) was a very general and broad study of the social sciences with possibilities of specializing in either law proper, economics, or sociology. Furthermore, being a veteran from World War I, Schutz was able to enroll into an accelerated study program at the university in Vienna with a two and half year program rather than the standard four year-curriculum.[19]

Little is known about Schutz's years as a student. What is known, among other things, is that he, despite later working as a banker, never considered economics to be his "own" discipline. As a student he primarily studied philosophy of law under Hans Kelsen, and it was from that perspective that he came to the social sciences and developed an interest in economics, philosophy, methodology, and–especially–sociology. It was also via that route that Schutz eventually came in contact with Mises and the intellectuals of the *Miseskreis*.[20]

By the time Schutz and Mises met, the latter was close to 40, a bachelor living with his mother, and without having achieved a tenured teaching position. But he was also the author of several important works on economics, sociology, and politics and widely recognized, even among his many adversaries, as an outstanding intellect and perhaps one of the greatest minds of Austria in that century.[21] Mises had attended the university in Vienna and received the degree of Doctor of Law (Dr. jur.) in 1906. Having become familiar with the works of the early Austrian economists, Mises attended Eugen von Böhm-Bawerk's post-graduate seminar at the university from 1904 to 1914, which at that time was the center for the continuance of Austrian economics. In 1907 Mises began working at the Viennese Chamber of Commerce, an official advisory agency of the Austrian government, and he held this position–interrupted by military service from 1914-18–full-time until 1934, while teaching part-time and being involved in numerous activities and projects.[22]

Silverman (1980, p. 46n. 2) and Voegelin (1989, p. 1). The *Miseskreis*, on the other hand, was according to most accounts by far the most influential social science circle, cf. Hayek (1994, p. 69).

[19]On these early years of Schutz's life, see Wagner (1983, pp. 5-8).

[20]Interview with Alfred Schutz, 20 November 1958 (p. 1).

[21]Cf. Mises (1984, pp. 14, 30). Among the most important works published by Mises by 1920 were (1980, 1983, and 1990).

[22]For some general and more comprehensive treatments of Mises's career, see his own (1978), as well as his widow Margit von Mises's (1984). See also Rothbard (1988).

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As with many of Mises's students, e.g., Hayek, Schutz actually never had Mises as a regular professor; they first met in 1920, in connection with one of Schutz's final exams.[23] In those years in Vienna the social sciences could only be studied as a part of the full-fledged Doctor of Law program (Dr. jur.), and the independent Doctor of Social Science program (Dr. rer. pol.) was not established until the year Schutz graduated, and while Hayek and other of Schutz's classmates after their graduation in 1921 went on to pursue their second doctorates, Schutz only got the first.[24] No dissertation was required in order to obtain the degree, but it was necessary to complete five tough comprehensive field examinations, which Schutz–despite his accelerated program–passed *summa cum laude*.

One of these was a special three hour examination in economics and international law, which were Schutz's majors; he had in 1919-20 concentrated his university studies on international law and had simultaneously been enrolled as a student at the Viennese Export Academy (later the the Institute for World Trade). Many years later, Schutz recalled how four candidates took the examination together before a governmental commission of economists who were appointed so that the students would not know their identity in advance.[25] While he and the other students who were to be examined were waiting outside the classroom, they looked down the staircase to spot the examiners as they were coming up–and when they saw Mises approaching, they all uttered an "Oh, oh!" Mises had taught at the Export Academy from 1918-19, and from his friends Schutz knew Mises by reputation–including one of being a very strict examiner.[26] That this was not an unfair characterization became evident during the examination when Mises asked a number of questions about capital goods theory and specifically about the works of John Bates Clark. Schutz had the impression that Mises recognized that he knew more about economics than the other students, and so Mises pursued his questioning of Schutz on various economic questions. One of the questions was whether he had actually read Clark's book, and Schutz answered "Truthfully, yes." Mises then asked Schutz if he had read it in the English original or in a German translation. Schutz replied, "I must answer truthfully, I read it in the English original." Schutz recalled that Mises replied to that, "It is good you answered as you did–because there is no German translation."[27]

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[23]Interview with Schutz (p. 1). Machlup seems to have been Mises's only "real" graduate student; Mises was his dissertation advisor and he was Mises's research assistant. Schutz was, as mentioned, a student of Kelsen, while Hayek was a student of Wieser, cf. Hayek (1994, p. 57).

[24]Interview with Schutz (p. 1). On Hayek's studies, see Hayek (1994, pp. 4, 64-65).

[25]Interview with Schutz (p. 1).

[26]Ibid., p. 2.

[27]Ibid., p. 2. Schutz further recalled, that he had told this story a number of times, and that Mises always thought it was a good one, although the last time Mises heard Schutz tell it he did not seem to like it.

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The Privatseminar

The little "trap" which Mises set for Schutz did not prevent the two from becoming very closely associated. Shortly after the examination, later in the year 1920, Schutz heard from his close friend Fritz Machlup that Mises gave "a very interesting private seminar" and that Schutz could attend if he wanted.[28] Schutz personally suspected that Kelsen might have been the real connection behind the invitation;[29] he was, after all, Kelsen's student and therefore suspected that after the examination Mises must have asked his colleague and friend Kelsen about Schutz before admitting him to his *Privatseminar*.[30]

To be asked to participate in the seminar was arguably somewhat of an honor for a young Viennese academic, not least because Mises was a well-known personality and scholar. Furthermore, the seminar was rather exclusive, with participation being by invitation and for doctors only, at least in principle.[31] It was, in other words, the best and brightest graduates from the university, handpicked by Mises. However, Schutz was, as he later recalled, not particularly interested when he first got the offer to participate. Nevertheless, as suggested by Machlup, he attended a meeting, although initially without a great deal of enthusiasm. Yet as Schutz kept going to the seminars, he increasingly found all the discussions there "most interesting" and "very stimulating."[32] Schutz in fact, came to find it so fascinating an intellectual forum that he not only was an early participant but also continued to participate as one of the most regular participants until its termination in 1934.[33]

Mises had initiated the seminar earlier in 1920, probably relatively shortly before Schutz was invited to attend it, and was supposedly initially inspired by Böhm-Bawerk's private seminar and as an offspring of another seminar, oriented more narrowly to economics, which Mises had conducted

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[28]Ibid.

[29]Ibid., p. 5.

[30]Ibid. Kelsen and Mises were—despite philosophical differences—close friends; they had known each other since school, when they were about 10 years old, and they had worked together at the Department of Economic Warfare during the war. They later spent several years together in Geneva after both having escaped Austria.

[31]Cf. Machlup in a letter to Margit von Mises (1984, pp. 202-03) and Wagner (1983, p. 12). According to Schutz's own recollection, the *Privatseminar* had at that time an average attendance of 15-20 persons; see Interview with Alfred Schutz, 20 November 1958 (p. 3). The requirement of a doctorate may be at least part of the explanation for the relatively late date of initial participation of a number of Mises's best students, e.g., Machlup.

[32]Interview with Schutz (p. 2).

[33]Hayek, no doubt the most famous of the members of the *Privatseminar*, did not participate until after his return from the U.S. in May 1924 and only until his departure for London, cf. Hayek (1994, pp. 9-10, 65, 69). As such Schutz, Machlup and Haberler must have been among the earliest of the participants to get to know Mises; Hayek did not meet

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at the university since 1918.[34] All accounts of the seminar stress the same features of its character, and Schutz's recollections support these. First of all, it was essentially a private, post-graduate, interdisciplinary social science seminar. Under the informal leadership of Mises as *primus inter pares*–as he later defined it himself–the seminar seems during the 1920s to have included a maximum of approximately 20 participants, with usually only about 12 participating at the same time, plus occasionally some additional visiting guests. Among those who participated as regulars over the years were–apart from Mises and Schutz–such later prominent economists, philosophers, sociologists, legal theorists, political scientists, and historians as Ludwig Bettelheim-Gabillon, Viktor Bloch, Martha Stephanie Braun (a.k.a. Steffy Browne), Friedrich Engel (von) Janosi, Walter Froelich, Gottfried (von) Haberler, Friedrich August von Hayek, Marianne (von) Herzfeld, Felix Kaufmann, Rudolf Klein, Helene Lieser(-Berger), Rudolf Loebl, Gertrud Lovasy, Fritz Machlup, Ilse Mintz(-Schüller), Oskar Morgenstern, Elly Offenheimer(-Spiro), Paul N. Rosenstein-Rodan, Karol Schlesinger, Fritz Schreier, Richard (von) Strigl, Erich Voegelin, and Robert Wälder. Others who participated more or less regularly included Karl Bode, J. Herbert (von) Furth, Fritz Kaufmann, Karl Menger, Ewald Schams, Erich Schiff, Alfred Stonier, Gerhard Tintner, and Emmanuel Winternitz.[35] The seminar also attracted, especially in the early 1930s, a very large number of prominent guests from abroad.[36] The interdisciplinary nature of the seminar was reflected by the composition of the participants, who, in Mises's own words, were united by a "burning interest" in the whole field of the sciences of human action, including problems of philosophy, epistemology, economic theory, and the various branches of historical research.

Mises until October 1921, when Hayek presented him with a letter of recommendation from Friedrich von Wieser (pp. 5-6, 57, 67-68).

[34]Prendergast (1986) sets the initiation of Mises's *Privatseminar* to 1922, while Margit von Mises and Fritz Kaufmann set the year to 1923 (Mises 1984, pp. 201-02). A number of very trustworthy sources do, however, point to 1920, e.g., Greaves (1993, p. 2), which also is in accordance with Schutz's recollections. On Mises's seminar at the university, see Mises (1984, p. 201); Haberler (1981, pp. 50-51); and Felix Kaufmann in a letter to Margit von Mises, quoted in Mises (1984, p. 202). On Böhm-Bawerk's seminar, see Hayek (1994, pp. 55-56).

[35]See, e.g., Engel-Janosi (1974, pp. 110-12); Mises (1984, pp. 201-02), Machlup in Mises (1984, pp. 202-03); Haberler (1981, p. 50); Rothbard (1988, pp. 49-50); Hayek (1992, p. 30; 1994, pp. 69, 70-71); and interview with J. Herbert Furth, 26 June 1993. There are slight discrepancies in the various accounts of who exactly participated in the *Privatseminar*, possibly due to a confusion of Mises's university seminar and his *Privatseminar*, and the present list is based upon a conjunction of the most authoritative of the sources. On Schutz's participation, see, e.g., Interview with Schutz; Mises (1978, p. 100); Machlup in M. Mises (1984, pp. 202-03); Haberler (1981, p. 50); Rothbard (1988, p. 49); and Hayek (1992, pp. 27, 31-32).

[36]On other guests from abroad, see, e.g., Haberler (1981, p. 50); Rothbard (1988, p. 50); B. Smith (1986, p. 28, n. 51); Hayek (1994, pp. 71-72).

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Occasionally Mises would simply "improvise" a lecture on the basis of some current topic, but in general the subjects of the sessions were decided upon by the members one year in advance, and often the subjects were centered around a common theme for a whole year, e.g., methodology, economic policy, and monetary policy.[37] Particularly popular among the participants seems to have been–according to several accounts–the year devoted to methodology.[38]

All accounts agree, that the *Privatseminar* was informal in style, but nevertheless had traditions and rites of its own, always underlined by Mises's own never failing punctuality and systematism. The participants met regularly twice a month, every second Friday, at 7:00 p.m. in Mises's private office at the *Handelskammer*. The seminar would be conducted with Mises sitting at his desk and the participants around him, usually sharing from a large box of chocolate candies, which Mises, much to the delight of the participants, circulated.[39] The meeting began either with a lecture by Mises himself or with a paper presented by a participant. The "always lively" discussion usually lasted until 9:30 or 10:00 p.m.[40] Schutz would later fondly recall–as several other participants have done–how the sessions of the seminar were almost always followed by dinner at the Italian restaurant *Anchora Verde*.[41] The conversations of the seminar continued during dinner, albeit usually in somewhat lighter tones. At 11:30, those who were not yet exhausted would go on to the famous Viennese coffeehouse, the *Café Künstler*. Mises was, according to Haberler, always "among the hardy ones" and the last to leave, never before 1:00 a.m.[42]

No list seems to exist of the complete series of lectures at the *Privatseminar* and there is no record of Schutz's contributions to the gatherings. Schutz himself later recalled[43] that it was here that he first lectured on Weber's methodology, and his papers do contain outline sketches of five lectures, yet considering how long he participated Schutz may have given more lectures of which, alas, there are no traces. The five lectures were given to the seminar in

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[37]See Machlup in letter to Margit von Mises (1984, p. 203).

[38]Ibid.

[39]Ibid.

[40]See Haberler (1981, p. 51); Machlup in letter to Margit von Mises (1984, p. 203).

[41]See Interview with Schutz (p. 3). The name of the restaurant was Italian for the "Green Anchor," but, Schutz explained, this was a mistranslation into Italian of the name of the street where the restaurant was located, *Grünangerstrasse*. In English this means "Green Meadow Street," but the restaurant owner apparently thought that "*Grünanger*" meant "*Grüne Anker*," i.e., "Green Anchor."

[42]Cf. Engel-Janosi (1974, p. 112); Haberler (1981, p. 51); and Interview with Schutz, p. 3. Haberler also recalled, how Mises nonetheless the next morning would be at his office at 9:00 a.m. sharp "fresh as a daisy" and kept this habit of working late and rising early well into his eighties.

[43]Interview with Schutz (p. 3).

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December 1928, March 1929, and June 1930. The first four, delivered in the winter of 1928-29, exist in the form of lecture outlines, which bear the designation "Mises Referat," and which have recently been published (Schutz 1996d). The lectures had the collective title of "Pragmatismus und Soziologie" and dealt with themes covering essential questions of sociological theory. The first dealt with Weber, the nature of human action and Max Scheler's *Erkenntnis und Arbeit*; while the second was on Leopold von Wiese's *Gebildelehre*; the third focused on the problem of intersubjective understanding in the light of Weber, Bergson, and Husserl; and the fourth applied the works of von Wiese, Scheler, Simmel; and others on the problem of a cultural ethos. Of the fifth lecture, given June 27, 1930, with the title "Verstehen und Handeln," there is no real outline preserved, only a set of guidelines for discussion, consisting of two short outline-texts and a fragment, which have also recently been published (Schutz 1996c). Wagner was able to establish that this lecture had brought a further extension of the considerations in the earlier lectures and was thus a conclusion. As such, it was essentially an outline of the central themes of what became Schutz's first and only completed book, *Der sinnhafte Aufbau der Sozialen Welt*, which was being drafted at that time and was published two years later.[44]

The Geistkreis

Schutz's personal and intellectual acquaintance with members of the Austrian School was not limited to Mises's biweekly *Privatseminar*. Rather his involvement in the intellectual life of interwar Vienna also extended to his participation in another quite famous Viennese circle, the so-called *Geistkreis*, i.e., the "Circle of Spirits."

The *Geistkreis* was founded in the autumn of 1921, the year after Mises had organized the *Privatseminar*. The founders were two of Schutz's classmates, Hayek and Furth, who at that time were not yet members of Mises's *Privatseminar*, and who were dissatisfied with the character of Othmar Spann's doctoral seminar and wanted to create an independent and broader alternative.[45] The *Geistkreis* also met once or twice a month, and its membership consisted of young academics with interests ranging all over the spectrum of the social sciences, and who were all distinguished by the originality of their work (and who often—but not exclusively—were Jewish). Its form was thus, as the *Privatseminar*, a social science seminar, whose members in lectures and lecture-series presented papers on, e.g., theoretical and methodological questions.[46]

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[44]On these manuscripts, see Wagner (1983, pp. 13, 34-35). See also Kauder (1965, pp. 122-23).

[45]Interview with J. Herbert Furth, 26 June 1993. On the *Geistkreis*, see, e.g., Engel-Janosi (1974, pp. 116-28); Voegelin (1989, pp. 4-6); and Hayek (1994, pp. 4-5, 58).

[46]Wagner (1983, pp. 12, 331 n.4) reports that while the members of the *Geistkreis* also lectured to each other, they were not allowed to lecture on subjects from their own

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But in the *Geistkreis* there was no *primus inter pares* because the circle was organized while several of the participants were still students and was always held privately. Furthermore, the number of members was smaller (limited to 12), and membership was for males only.[47] The original idea had been to find at least one specialist in each subfield within the humanties and social sciences. As such, the topics of the lectures had a wider and more cultural breadth, e.g., legal theory, political theory, public policy, history, religion, and the arts, and the topics occasionally touched upon lighter tones. Schutz seems to have presented six papers to the circle, namely on "The Meaning of the Opera," "The Theory of Music," "Theory of Language," "Graphology," and "The Joke" (in two lectures).[48] All in all, the *Geistkreis* was a circle of intellectual, good friends, a place where they could present their ideas to their equals under relaxed circumstances. But while the focus and form of this circle was somewhat different from that of the *Privatseminar*, a significant overlap between the two circles both in terms of participants and subjects. Indeed, approximately half of the total number of members of the *Geistkreis* over the years were or eventually became more or less regular participants in the *Privatseminar*.[49]

Schutz, Mises, and the Friends of the Miseskreis

When trying to evaluate how the social environment intertwined with Schutz's intellectual development one should not underestimate the role which these circles played keeping a number of young, hopeful academics, essentially centered around Mises, together in a combined intellectual and social community of scholar-friends. And in this way the importance for Schutz of these two circles, and especially the *Privatseminar*, can hardly be overestimated; the seminar consisted (or came to consist) of a collection of people, who simultaneously were among Schutz's closest personal friends and, since he did not have a teaching position, the closest he came to having academic colleagues. This group was, in other words, the environment in

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field of specialization. This claim is, however, contradicted by two of the cofounders, Gottfried Haberler and J. Herbert Furth (interview with Furth).

[47]Interview with Furth, and Engel-Janosi (1974, p. 116). The reason for excluding women was supposedly not male chauvinism but a desire to avoid a particular woman of their social circle and the fear that male members would continue to suggest whatever girlfriends they had as members. The name of the circle was, according to Furth, given by the wife of a member as a humorous protest against women being excluded from participating. Cf. ibid. and Craver (1986, pp. 16-17).

[48]Interview with Furth, and Wagner (1983, p. 12). Cf. the supposedly complete list of presentations 1921-38 in Engel-Janosi (1974, pp. 125-28).

[49]These were—in addition to Hayek, Furth, and Schutz—Engel-Janosi, Froelich, Haberler, Kaufmann, Machlup, Menger, Morgenstern, Voegelin, Winternitz, and Wälder, cf. Interview with Furth, and Engel-Janosi (1974, pp. 117ff.); Craver (1986, pp. 16-17); and Hayek (1994, p. 58). In its 17 years of existence, the *Geistkreis* had a total of 25 members.

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which Schutz initially formed his ideas, and the forum where he first tried them out.

Schutz knew, as indicated, some of these persons before entering the *Privatseminar* and the *Geistkreis*, but it was through these circles that they were kept together in a community. Machlup and Schutz seem to have been friends before 1920, but through these circles it came to be a very close personal and intellectual acquaintance, which spanned four decades. Schutz and Hayek were, as mentioned, in the same class at the university, which also was where the friendships with Furth and Voegelin were initially made. Haberler and Morgenstern, as young economists, were singled out by Schutz; a friendship and admiration that would last for years.[50] Of the noneconomists who influenced him, Schutz pointed to Felix Kaufmann, who as a philosopher was interested in methodology and the philosophy of law, and to Voegelin, who as a *Privatdozent* at the university also participated in the seminar.[51] But no doubt the central influence was Mises himself.

While Mises throughout these years generally remained on friendly terms with the participants of the *Privatseminar*, he was known as a very private man. Hayek and Machlup—both economists and classical liberals—are usually and rightfully singled out as Mises's particularly close associates, while Schutz, on the other hand, was neither an economist proper nor a vocal classical liberal, and hence not one of those to publicly carry the standard of the Austrian School. Yet a consideration of a number of facts revealed in, among other places, various private papers shows that Schutz probably was among those of his generation closest to Mises.

Schutz himself reported that he always considered Mises to be "a close friend," and it was Schutz's impression, that Mises liked him too.[52] The nature of their early friendship is possibly reflected in the fact that it usually was Schutz and Machlup who accompanied Mises home after the evening gatherings—after which the two young men would continue to talk for many hours, sometimes even until 3:00 or 4:00 a.m.[53] Mises's early appreciation of Schutz is also evident from the fact that Schutz—unlikely to obtain a teaching position—three weeks before he received his degree of Dr. jur. in December 1921, was offered his first job, and as in so many other instances, it was Mises who was the sponsor and middleman for his protégés. Mises was at that time first secretary (and later general secretary) of the Banking and Financial Department of the Chamber of Commerce, and a banker from Vienna had asked Mises if he knew somebody who could become secretary of an organization of smaller Austrian banks. Mises asked Schutz if he was interested, and when

[50]Interview with Schutz (p. 1).

[51]Ibid.

[52]Ibid., pp. 3 and 6. Cf. Voegelin (1989, pp. 6-7).

[53]Interview with Schutz (p. 3). Cf. Machlup in letter to Margit von Mises (1984, pp. 202-03).

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he answered affirmatively, Mises suggested him for the position. Schutz, despite his desire for an academic rather than a banking career, always remained grateful for this act.[54]

Schutz's appreciation of Mises did, however, extend far beyond personal gratitude to explicit, though not uncritical, admiration. Although Schutz had never had Mises as a regular professor, he had second-hand knowledge thereof via friends from the Export Academy and from the other participants in the *Privatseminar*, and it was very favorable. At the Export Academy Mises had taught an introductory course in economics, primarily to officers seeking to return to civilian life. Schutz himself had taken courses there, though without having Mises as a teacher. But his friends, who attended these courses without previously having been particularly interested in economics, suddenly became very enthuasiastic and this was due to the way Mises presented the subject.[55] Schutz's experience was also of Mises as an intellectual. According to Schutz Mises was always "brilliant and full of wit," when he spoke in German; he was "one of the best speakers" Schutz had ever known, and Schutz characterized Mises's repartee and conversation as "brilliant."[56]

Schutz, as so many others of Mises's associates, was of the impression that their mentor was poorly treated, because he did not receive the position and honors he deserved. First and foremost Mises was never made a full professor in Vienna (or for that matter in New York); he had always taught economics, but it was only part-time and simultaneous will his full-time work and writing projects. He was appointed *Privatdozent*, i.e., unsalaried part-time lecturer, at the university in 1913, and in 1918 he received the title of "Professor Extraordinary" without salary–a position he held until 1934.[57] The fact that Mises was not treated as he truly deserved, did, according to Schutz, hurt Mises very much,[58] and Schutz was very clear in what he himself thought of this:

> While "zeroes" like [Hans] Mayer, who never published anything and who didn't amount to anything were made professors, Mises never had that honor. Mises was the leading pupil of Böhm-Bawerk and was considered really the second man in the Austrian School, second that is to Schumpeter.[59]

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[54]Interview with Schutz (pp. 3-4) and Mises (1984, p. 60). It was thus accidental that Schutz entered the same branch of business as his stepfather (and uncle), Otto Schutz.

[55]Interview with Schutz (p. 5).

[56]Ibid.

[57]Ibid., p. 7. Mises was passed over no less than four times, and each time in favor of scholars commonly acknowledged as less competent. See Craver (1986, pp. 2-8) and Hayek (1994, pp. 59-60).

[58]Interview with Schutz (p. 7).

[59]Ibid.

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Schutz summarized his own explanations of why Mises was so unfairly treated in three points: that Mises was Jewish, that he was seen as uncompromising on questions of methodology, economic theory, and politics, and that he was seen as being too "practically" oriented and not sufficiently "academic."[60]

Schutz and his contemporaries were convinced that it was not least due to the fact that Mises–like several other members of the *Miseskreis*, including Machlup and Schutz himself–was Jewish, that hurt his career in Austria: "[N]o Jew could become a full professor in Vienna, even before Hitler. If you were baptized, as Kelsen was, then perhaps one could be appointed professor." Likewise, Schutz pointed out, the Jewish Felix Kaufmann, was–like Mises–only a *Privatdozent* at the university and also held a leading position in the Anglo-Persian Oil Company in Vienna. Schutz himself wanted to remain aloof from all this prejudice and never even cared to apply to become *Privatdozent*.[61]

The second reason for the mistreatment of Mises was in Schutz's opinion his general unwillingness to compromise on questions where he had principled convictions. Mises, Schutz later recalled, consistently resisted the then dramatically increasing tendency to formalize economics via mathematics rather than verbal logic and to turn the building of economic theory into econometric testing. This latter approach Mises saw as nothing else but a return to the historicism which he, in the spirit of Menger, had fought so hard. According to Schutz, Mises considered this mathematical treatment of economics neither "necessary" nor "useful." Schutz especially singled out Pareto, Wicksell, and Jevons as having been the objects of Mises's methodological critiques in the 1920s. Whatever Schutz himself may have thought of the validity of the epistemological and methodological foundations of his mentor's critique of economics, he himself certainly had a more practical and rather pragmatist view of the question. As Schutz put it in the late 1950s: "You know, that mathematics is now necessary for economics. One has to master the mathematical treatment, if one expects to teach at Princeton, Harvard, Johns

[60]It was the general opinion among the members of the *Privatseminar*, that Mises was unfairly treated, cf., e.g., Engel-Janosi (1974, pp. 110-12); Fritz Kaufmann in Mises (1984, p. 202); Hayek (1988, p. 3); and Machlup (1982, pp. 10-11). See also Hayek (1994, p. 59). It is interesting to note that almost all of the participants who have recorded their explanations of the treatment of Mises seem to agree on the major reasons, albeit with slightly different emphasis. Schutz, for example, is not on record for sharing the otherwise widespread view that Mises also tended to be personally abrasive. The general points made by Schutz, Kaufmann, and Hayek have also been made in conversation by Gottfried Haberler and J. Herbert Furth (interviews, 11 June 1993). See also Craver (1986, p. 5), who additionally refers to interviews with Hayek and Machlup. Many of Mises's protégés agreed that while his brilliance might have made it possible for him to overcome some of the criticism directed against him it was their combined weight which made this impossible. See especially Hayek (1994, p. 59).

[61]Interview with Schutz (p. 7).

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Hopkins, etc."[62] Schutz even ventured the suggestion, that Mises might possibly have had a private "hatred" of mathematics because of disagreement with his own brother, the noted positivist and mathematician, Richard von Mises. Ludwig and Richard had at an early age gone their separate ways without any contact at all, and they only met briefly at their mother's funeral in Vienna in April 1937. Schutz himself first met Richard von Mises about 1937 through a professor in Vienna, who invited both of them to a lunch with a number of professors. Schutz's friend introduced him to Richard von Mises as a "favorite student of Ludwig's." The second Mises then became pale, turned away from Schutz and did not speak to him throughout the entire lunch.[63] Schutz believed the origin of the hostility between the two to be "basic ideological differences."[64] Ludwig von Mises did not even know that his brother was married—something which Schutz had to tell him. Schutz later noted that he was glad that their relationship softened somewhat after they both came to the U.S.[65]

But Mises's third problem was, according to Schutz, his radicalism in political opinions and his way of viewing his opponents; both kept him out of the mainstream and away from a tenured position. Schutz seems to have respected his mentor's idealism and—contrary to Wagner's claims—to have basically shared his liberal philosophy, while having a more "pragmatic" approach to politics. He put it this way, while Mises was still alive:

> With respect to the differences between Mises and his students, Mises was the only consistent thinker in terms of liberalism who made no concession. He has fought all kinds of interference by the government. He has fought continually since Keynes and his doctrines. . . . [But h]e has always been so radical that everyone has had as an argument against Mises that his proposals are not possible politically in our times. You have to make concessions. This attitude developed partially with Mises into a kind of obsession. If somebody didn't accept liberalism in its purity, Mises suspected that he was a socialist, Marxist, etc.[66]

Several of Mises's students, including Hayek, Machlup, and Haberler, have given more or less the same points as the reasons for the treatment of Mises. But Schutz added another one: According to Schutz it was—curiously enough—not only Mises's radicalism but also partly his very specific, policy-oriented

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[62]Ibid., p. 8.

[63]Ibid., p. 9.

[64]Ibid., p. 9. This is also partly the explanation reported by Rothbard (1988).

[65]Interview with Schutz, p. 9. The relationship improved somewhat after Ludwig von Mises's marriage, and the couple met with Richard in Geneva in 1939 and stayed in contact with him after they came to the U.S., where Richard was a professor of Aviation and Mathematics at Harvard University until his death in 1953. Cf. Mises (1984, p. 17).

[66]Interview with Schutz (p. 8). Cf. the somewhat similar description of Mises's uncompromising personality and politics, Machlup (1982, pp. 9-10, 12-15).

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and practical work that kept him out of the mainstream of academia. As Schutz recalled 25 years later:

> There was another prejudice in Vienna against "practical" men. It was thought that you couldn't be a serious scientist if you were dealing with practical problems as Mises was in the Chamber of Commerce. You could perhaps, be a Dozent, but you couldn't be advanced.[67]

Saying this Schutz later recalled with admiration how Mises—though occupied with his full-time work and intellectual pursuits—started many important and interesting things in his business career. Schutz pointed to how Mises was an active member in the *Verein für Sozialpolitik* (Association for Social Policy), and organized the Committee of Bankers and Industrialists and, the organization called *Steuerpolitisches Aktionskomité* (Task Force on Tax Policy), the *Abrechnungs Amt* (Austrian Reparations Commission of the League of Nations), and the *Österreichische Gesellschaft für Nationalökonomie* (Austrian National Economics Association) and its quarterly economics journal, the *Zeitschrift für Nationalökonomie*. Another very important organization, which Schutz pointed towards as having had Mises as the primary driving force in its establishment and work, was the *Österreichisches Institut für Kunjunkturforschung*. Schutz himself met Mises in a professional capacity in Vienna in 1924, when the new Austrian National Bank was formed with the help of the League of Nations, and Mises played a very important role in drafting the statutes and by-laws.[68]

Many of these projects and activities incidentally also managed to lighten some of the effects of the discrimination, which was leveled not only against Mises but also—in their younger years—extended to his favorite seminar participants. Many of them were also Jewish, and their association with Mises did not help their position in the departmental fights over jobs. Accordingly, though all were doctors, and several also had their habilitation-degrees, only Kaufmann, Hayek, Haberler, Morgenstern, and Voegelin became *Privatdozenten*, and not a single one obtained a full professorship at the university. Machlup was manager of his family's cardboard factory, Engel-Janosi produced wooden floors, Schlesinger, Bloch, Lieser, Herzfeld, and Schutz were into either commercial banking or banking organizations, Kaufmann was an executive in the oil industry, Strigl worked as a staff-member at the Chamber of Labour, and Froelich, Furth, and Winternitz practiced law.[69] Mises's many activities provided many of them with work, i.e., positions which Mises created for them or helped them get. Haberler's first job was as library consultant

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[67]Interview with Schutz (p. 7).

[68]Ibid., p. 4.

[69]Cf. Engel-Janosi (1974, p. 111); Machlup in letter to Margit von Mises, in Mises (1984, p. 202); and Hayek (1992, p. 31). See also Craver (1986).

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at the *Handelskammer*, and Hayek's first was as secretary of the *Abrechnungs Amt*–and Haberler got this job when Hayek left for the U.S. in 1922.[70] In 1927, when Mises had become executive vice president of the *Institut*, Hayek became its first secretary, i.e., manager, while Haberler, Morgenstern, and Schiff also received positions at the institute.[71]

Schutz may have disagreed with his mentor on the desirable speed and radicalism of liberal reform, but he had no second thoughts about the quality of Mises's analytical abilities. Schutz–like so many others who knew him–recalled with awe how Mises time and time again amazed them and others by his ability to predict political-economic changes.[72] And this ability was indeed, according to Schutz, indirectly one of the reasons why Mises never got a full professorship at the university. For he had, in Schutz's words, seen the dangers of both international and national socialism from the outset. He foresaw its development in Austria in a way which Schutz in retrospect described as "absolutely correctly,"[73] and specifically the conflict that would arise in Vienna. One day, Schutz later recalled, when he and Mises were in conversation while walking in Ringstrasse, Mises stopped and stated it in an allegory: "Grass will grow right here where we are standing."[74]

Machlup many years later agreed with Schutz's recollection by pointing out that while Mises never engaged in quantitative predictions, he had a "gift of prophecy" in the form of "uncanny powers of qualitative foresight." Mises, e.g., anticipated in 1924 the collapse in 1931 of the *Kreditanstalt*, and in 1927 he foresaw the end of freedom in Central Europe, and how that would make it impossible for the members of the *Miseskreis* to stay in their native Austria. Machlup specifically recollected the now famous story of how Mises jokingly, with tongue in cheek and the famous glint in his eyes, had imagined what jobs he and his friends would be able to get. The vision was that they would all end up in a nightclub in Latin America; Kaufmann would be a crooner, Hayek a waiter, Machlup a dancer and gigolo, and his wife Mizzi a hostess, barmaid or go-go girl. Mises realized that he himself unfortunately had none of these qualities and therefore would have to do with being the doorman in a uniform outside the place.[75]

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[70]Interview with Schutz, 20 November 1958 (p. 4); Hayek (1994, pp. 9, 64, 67-68).

[71]Interview with Schutz (pp. 4-5); Hayek (1994, pp. 9, 67-68).

[72]Interview with Schutz (p. 7). See also Mises (1984, p. 46) and Machlup in letter to Margit von Mises (Mises 1984, p. 205).

[73]Interview with Schutz (p. 7).

[74]Ibid., p. 9. Greaves (1995, p. 7) attributes this statement to an exchange between Mises and Machlup in the former's office in the *Handelskammer*.

[75]See Machlup (1974, 1981) and in letter to Margit von Mises (Mises 1984, p. 205). For another account of Mises's foresight and his prediction of the emigration of the *Miseskreis*, see Greaves (1995, pp. 6-7).

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The Emigration of the Austrians

There was to be some ironic truth in Mises's prediction, at least symbolically, for in the years to come the participants in the *Privatseminar* all emigrated,[76] and in some sense Mises became the "doorman." For while Hayek had already left for London in 1931, and Machlup for the U.S. in 1933, it was more or less his own departure in 1934, that signaled the final breakup of the *Miseskreis*.

According to Schutz, Mises's only mistakes in the analysis of politics was the timing; Mises always thought things would come sooner than they did, and that people would be "as intelligent as he was."[77] Because Mises saw the coming of (national) socialism in Austria, he knew he could not advance in Vienna. Therefore, Schutz later recalled, when Mises had completed enough years at the *Handelskammer* to get a pension, he accepted the position in Geneva, where he "could have an audience worthy of his position."[78] In the summer of 1934—shortly after the murder of the Austrian chancellor Dollfuss—Mises received the offer of an appointment as professor of International Economic Relations at the Graduate Institute of International Studies in Geneva, Switzerland. Mises accepted the appointment and left in October 1934, while formally only taking leave of absence from his other positions and thus retaining his association with the *Handelskammer* on a part-time basis until 1938.[79] This meant the effective dissolution of the *Privatseminar*, and Felix Kaufmann, the poet of the circle, even wrote two goodbye-songs for the occasion of Mises's departure.[80] The *Geistkreis* was also affected by the emigration of its members, although its remaining members tried to keep up the spirit of the circle until its final season of lectures in the winter of 1937-38.

Mises often returned to Vienna during these years and continued his affiliation with the organizations and people that he had worked with and with his closest friends. Mises was indeed visiting in Schutz's home a few hours before Schutz's youngest son was born, on 23 February 1938.[81] It later turned out that the very private Mises had not just been on one of his regular visits to Vienna but was there in order to arrange his marriage to Margit Sereny (*née* Herzfeld) later the same year. Mises did not mention it at all the evening of 22

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[76]Machlup even credited Mises with probably having saved his life.

[77]Interview with Schutz (p. 7).

[78]Ibid., pp. 7-8.

[79]Cf. Mises (1984, pp. 25-26). Wagner erroneously reports that Mises was still in Vienna at the time of the *Anschluss* and only then "immediately relinquished his position at the university and went to Switzerland, where he found a teaching position in Geneva" (Wagner 1983, p. 63).

[80]Kaufmann's very amusing songs on philosophy and economics, most of which were written for the *Miseskreis*, have been collected and published by Haberler and Helmstädter (1992) with an introduction by Furth (1992).

[81]Interview with Schutz (p. 6).

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February, though, as Schutz later recalled, the marriage must have been completely planned.[82] The Mises wedding was set for Easter in early April, but the rapid and dramatic historical events of March 1938 changed that. On the night of the arrival of the German troops to Vienna, Nazi troops broke into the apartment, where Mises—the Jewish, staunch and vocal critic of totalitarianism—had lived for years with his mother, ransacked it and in two trips removed 38 cases containing his valuable library, writings, and documents including 2,500 books and 1,500 articles.[83] A few days later, on 14 March, Hitler arrived. Within a week after *Anschluss* Mises and all other Jewish members of the *Nationalökonomische Gesellschaft*, most likely including Schutz and Machlup, received a letter dated 19 March 1938 expelling them as non-Aryans; it was signed by their colleague, Hans Mayer.

Under these circumstances Mises could not return from Geneva to be married in Austria, instead the future Mrs. von Mises escaped to Switzerland, where the wedding took place on 6 July with Mises's close friend and Schutz's other mentor Hans Kelsen and the *Privatseminar*-participant Haberler as the two witnesses.[84] Schutz himself had gone to Paris on 5 March 1938, "on a business trip, with only two suits and three shirts," and he never returned to Vienna.[85] Ilse Schutz left the Austrian capital on 11 June and traveled to Paris with their children, including a newborn baby. From Paris the Schutz family traveled on to the U.S. in June 1939.[86] Schutz thus—just like Mises—lost his beloved library: First in Vienna and a second time in Paris, where he had begun accumulating books which he had to leave behind when he left for the U.S. Mises, on the contrary, fond of his marital and scholarly happiness in Geneva, committed what his wife later called "the only political error I ever knew him to make."[87] It was indeed a potentially fatal error; Mises mistakenly believed that France would and could fight the Germans, and that the defeat of Hitler was imminent. Accordingly he did not agree to leave for the U.S. until the Swastika literally was flying over Paris and Switzerland was surrounded by the Axis-powers. And so, on 4 July 1940, Mises left his beloved position and home in Geneva for a not very attractive offer to become a visiting lecturer and associate research professor at the University of California.[88]

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[82]Ibid.

[83]Cf. Mises (1984, p. 28). Cf. also a document entitled *Information*, dated Geneva, 4 March 1939. Richard Ebeling was the first to examine Mises's library and private papers in Moscow after their discovery in the early 1990s.

[84]Cf. Mises (1984, pp. 29-33).

[85]Interview with Schutz, p. 6. See also Wagner (1983, pp. 63-64). Wagner erroneously reports that Schutz first saw his newborn son in Paris.

[86]Interview with Schutz (p. 6).

[87]Mises (1984, p. 46).

[88]Cf. Mises (1984, pp. 46-49). This was one of several job offers to Mises, which Machlup facilitated, but which never completely worked out, cf. Fritz Machlup, Letter to

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The close nature of the relationship between Mises and Schutz is most evident from the fact that it was Schutz who, to their great relief, greeted the Mises couple on the pier in New Jersey, when they arrived there at noon 2 August 1940, having traveled almost a month from Geneva via France, Spain, and Portugal.[89] Schutz helped the couple find a place to live, and he sponsored Mises's naturalization as an American citizen in 1946.[90] In New York the friendship between the two Austrians and their families grew. Schutz later stated that he knew Mises "very well" and that he and Mrs. von Mises were "as good friends as one can have in New York." Schutz noted that he found it "difficult to cultivate close friendships in New York," but that Mises was one of the persons he saw regularly, and that also their wives got along very well.[91] The first years in their new country were somewhat unhappy for Mises, who missed his work, books, income and the intellectual life and environment he had enjoyed in Vienna and Geneva. Margit von Mises later recollected how during this period their almost only comfort was the maintenance of the friendships with their emigrated countrymen, such as Kaufmann, Machlup, and "that most interesting personality" Schutz and his wife Ilse, with whom they were "especially close."[92] The friendship ended after four decades with Schutz's much too early death in 1959.

Some Conjectures

So far nothing has been said here about phenomenology, interpretive sociology, or praxeology—about how Schutz's work may or may not be compatible with that of the Austrians. This is, however, neither the place nor the occasion to enter into detailed analysis of how Schutz's work may or may not fit in with that of Mises, Hayek, and Machlup—something which would go far beyond the limits of this paper. Such a task has already to some extent been considered by others (e.g., Koppl 1997, 1998), and I have myself considered some of these issues elsewhere (Kurrild-Klitgaard 2001).

Nonetheless, given the predominantly biographical material considered here one might quite naturally ask how Schutz's participation in the *Miseskreis* may have influenced him. Reading the accounts given by, e.g., Wagner one might conclude, that it may have done so as a source of stimulating Schutz's already existing interests, but only to a limited extent and without in

F.A. Hayek, 17 April 1940; Letter to F.A. Hayek, 13 September 1940; Letter to F.A. Hayek, 12 November 1940; Letter to F.A. Hayek, 10 June 1941, all at Hoover Institution, Stanford University.

[89]Cf. Mises (1984, pp. 55-57, 60).

[90]Interview with Schutz (p. 6).

[91]Ibid.

[92]See Mises (1984, pp. 57-60).

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any way being decisive in directing these interests. This is very clearly illustrated in Wagner's (1983, p. 337) schematic outline of Schutz's intellectual development which does not mention Mises, the *Privatseminar*, or the Austrian School at all.

A key to understanding the direction which Schutz's work was to take must no doubt be his decision to try to reformulate Weber's sociology and to do so by integrating it with Husserl's phenomenology. So what is Wagner's explanation? Wagner held that the reason Schutz involved himself in the study of Weber was his early interest in formulating a social scientific methodology that could bridge the gap between economics and sociology:

> Only the technicians in applied fields respected the boundaries of given academic disciplines. All serious theorists, regardless of their approaches, knew that the social reality was larger than any theoretically defined domain. They may have assigned a preferential position to their own discipline within the conglomerate of social-science disciplines, as von Mises did. But they readily took in territories which, by definition, lay outside the boundaries of their discipline to the fields of the social sciences. And his economic studies beyond the realm of his technical-professional specialization encouraged him to bridge the formal gap between theoretical Economics and Sociology. (Wagner 1983, p. 13)

Wagner furthermore notes: "Undoubtedly, the traditional inclination toward considering the social sciences as a diversified unity rather than as a conglomerate of disjointed specialties left its permanent imprint on Schutz," and "When Schutz decided to study Weber's work intensively, he set out on the path of his intellectual destination" (Wagner 1983, p. 13). Wagner does, however, not attribute this choice of Schutz's to any inspiration from his teachers: "[N]one of them could have possibly steered him in the direction of this giant of German Sociology" (ibid.).[93] But while the first points are central, the latter is wrong on several accounts, at least if Mises is thought of as being Schutz's teacher. This may be true in the case of Kelsen, whose organicist-holistic and positivist approach to the study of law and society was at odds with Weber's methodology; it is certainly not true of Mises. Mises was critical of Weber, but this is not the entire story; it was not an outright rejection, but

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[93]Wagner attributes Schutz's interest in Weber to

> those of his fellow students who had been able to spend the last year of the war at the University of Vienna. Weber had taught there during the first semester of 1918. He drew enthusiastic crowds of students and intellectuals. When, in the fall, he moved back to Germany, he left behind a large articulate following. As a student then, Schutz was exposed to the reverberations of Weber's "teaching charisma." (Wagner 1983, p. 14)

This may be true, but it does not in any way contradict what is argued here; that Mises was instrumental in stimulating Schutz's interest in Weber and influencing his views.

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rather a critical appreciation. Schutz recognized this in his 1932 work, which Mises himself praised the following year for having reformulated Weber.[94]

Furthermore, Mises did exactly share with Weber the view, which Schutz was to make his own, that the social sciences should be approached in a methodologically individualist manner. Since his earliest years as an economist Mises had, following in the footsteps of Menger and Böhm-Bawerk, been occupied with the formulation of a general science of human action, seeing economics only to be one–albeit the best developed–part thereof. By the 1920s Mises had mostly finished his own views of this integration of the social sciences in the form "praxeology," yet he did not use this term until 1930-31. In 1929, Mises still considered praxeology as identical with sociology broadly understood, with economics simply being a part thereof.[95] This point is obviously missed by Wagner, both in his view of Mises's project and in his neglect of Mises's influence upon Schutz.

As a third point, it should be stressed that Mises was very familiar with Weber's work. Mises knew Weber personally and professionally long before the posthumous publication of Weber's *Wirtschaft und Gesellschaft* in 1921 (1968) and the collection of methodological essays, *Gesammelte Aufsätze zur Wissenschaftslehre* (1922), which Schutz–according to Wagner (1983, p. 14) himself–quite obviously did not have a chance to know before they appeared.

Finally, and perhaps more significantly, it in fact was Mises who first stimulated Schutz's interest in the works of Weber who was well known among many young Austrians due to his visiting professorship at the University.

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[94]Mises said:

> Max Weber's epistemology has been continued and revised by Alfred Schütz in a way which also seeks to dispose of the judgment of the logical character of economic propositions to which I objected. Schütz's penetrating investigations, based on Husserl's system, lead to findings whose importance and fruitfulness, both for epistemology and historical science itself, must be valued very highly. However, an evaluation of the concept of the ideal type, as it is newly conceived by Schutz, would exceed the scope of this treatise. I must reserve dealing with his ideas for another work. (Mises 1981, pp. 125-26, n. 27)

This was, however, something which Mises unfortunately never did, not even in *Theory and History* (1984).

[95]Cf. Mises said:

> I still believed that it was unnecessary to introduce a new term to signify the general theoretical science of human action as distinguished from the historical studies dealing with human action performed in the past. I thought that it would be possible to employ for this purpose the term sociology, which in the opinion of some authors was designed to signify such a general theoretical science. Only later did I realize that this was not expedient and adopted the term praxeology. (Mises 1981, p. xvi)

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Hayek, for example, who even considered following Weber to Munich to study with him, put it this way: "Max Weber had taught in Vienna the year I was fighting [as a soldier in World War I] in Italy, and when I returned the following year, the university was full of talk about that great man." (Hayek 1994, p. 64). When Schutz first began participating in the *Privatseminar* he told Mises that he was interested in sociology rather than in economics proper. Yet this was no problem for Mises who continuously emphasized the broad social scientific character of the seminar, and he gave Schutz assignments right away.[96] Shutz's very first assignment for the *Privatseminar* was, as previously mentioned, Weber's methodology.[97] In other words, there seems to be no reason why Mises should not have been the one who led Schutz to Weber.

Another interesting question is whether the generally free market oriented liberalism, which characterized the political opinions of the majority of the participants in the *Privatseminar* was shared by Schutz. Here, Wagner again focuses on the possible points of disagreement at the cost of both accuracy and possible points of agreement; he notes that Schutz "in contrast to von Hayek and in agreement with many other students of von Mises . . . did not subscribe to the extreme economic liberalism of his teacher" (Wagner 1983, p. 12). While it is true that many of the members of the *Privatseminar*, like Schutz, were less radical free-marketeers than Mises, there seems little reason to hold that Schutz did not basically share the liberalism characteristic of the Austrians. On the contrary, Schutz's previously quoted remarks on Mises's liberalism stress that where he disagreed with Mises was on strategy and practical policy-issues, rather than on the fundamental issues–i.e., on the speed and methods rather than the direction. Now, it should be remarked that Schutz rarely wrote on explicit normative issues with political-ideological implications, and accordingly he is hard to qualify in such terms. Hayek, one of Schutz's oldest acquaintances, has confirmed both these points: "I am pretty sure he was what one called then a liberal–what one now calls a conservative . . . [though] I doubt very much that he was really a libertarian. But I do not know."[98] That Schutz should have been unsympathetic to the free-market liberalism traditionally associated with the Austrian School is suspect because he seems to have liked Hayek's controversial *The Road to Serfdom* (1944) very much. Schutz used the book as a present to the economist Adolph Lowe, who disliked the Austrian School and its liberalism intensely, and Schutz was at some point even considering writing a major essay analyzing some of the criticism directed against the book.

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[96]Interview with Schutz (p. 2).

[97]Ibid., p. 3. Later Schutz, among other assignments, reported on Wieser and Sombart.

[98]F.A. Hayek, Letter to Helmut Wagner, 8 January 1975 (Beinecke Library, Yale University). Engel-Janosi (1974, p. 119) also believed that most of the of the members of the *Geistkreis* were "liberals in the European sense," but that "such subjects were not discussed."

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Schutz's "quiet" liberalism is also evident from the neglected fact that he was a very early associate and eventually a member of the Mont Pélèrin Society, the rather exclusive classical liberal, libertarian, and conservative forum founded by Hayek. He must thus have been considered as belonging in that camp–both by himself and by whom he joined.[99]

Conclusion

All in all, it seems clear that the *Miseskreis* must have influenced Schutz significantly, and much more than acknowledged by Wagner. Schutz participated in the seminar not only in the years in which he formed the foundations of his phenomenology, but even before this. After just three years at the university this group of friends and colleagues provided him with a forum of peers interested in the very same problems–the only forum he had, and probably the best he could possibly get, for formulating, developing, and presenting his own ideas.

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[99]See Haberler (1981, p. 50). Hayek informed Schutz of his plans to found a society of classical liberals in a letter of 13 August 1945. A year later Hayek formally invited a group of 39 of the world's most prominent classical-liberal economists, philosophers, jurists, sociologists, political scientists, historians, and journalists to form a society to exchange ideas on the nature of a free society. The society was founded 1 April 1947, and among the founders were Hayek, Mises, Machlup, and Robbins, as well as Karl Popper, Michael Polanyi, and the later Nobel Laureates Milton Friedman, George Stigler, and Maurice Allais. Schutz was–contrary to Wagner's assertion (1983, p. 159)–among the invited, and he clearly was interested in the society. Though he did not participate in the founding meeting, he continuously received and saved invitations and programs, participated in the society's first ordinary biannual meeting in 1949, and eventually did become a full member in 1955.

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Does Austrian Business Cycle Theory Help Explain the Dot-Com Boom and Bust?

Gene Callahan and Roger W. Garrison

The American economy underwent a dramatic boom-bust cycle during the years 1995-2002. The height of the boom was characterized by enormous increases in stock prices, and especially the prices of Internet-related assets (with the necessary degree of "relatedness" declining as the boom progressed). The bust saw the rapid decline of most of the same prices. The Internet companies whose share prices were bid up came to be known as "dot-com" companies, from the common Internet domain name extension, ".com." Though the most dramatic manifestation of cyclical movement was observed in the dot-coms, the episode had clear macroeconomic significance. The cycle in stock prices was reflected by a similar cyclical movement in economy-wide unemployment, the unemployment rate falling from its 5.6-5.7 percent range during the last three quarters of 1995 to its record low of 3.9 percent in 2000 and then rising to 5.9-6.0 percent in 2002.

Does Austrian business cycle theory (ABCT) help explain what we will call the dot-com boom-and-bust cycle? And just what sort of an explanation can we expect ABCT to yield?

Because ABCT is a theory of how individual actors will choose in the face of certain forms of central bank activity, the natural mode in which to employ ABCT is that of historical explanation rather than formal modeling.[1] As Boettke (1994, p. 5) says, "Historical interpretation illustrates the power of the

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[1]Not to say that ABCT cannot be formally modeled. Indeed, Garrison (2001) is one such model, while other, simulation-based systems employing autonomous agents are possible.

THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 6, NO. 2 (SUMMER 2003): 67-98

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theoretical framework adopted." In the Austrian tradition, empirical evidence is virtually synonymous with historical evidence.

Furthermore, ABCT is not *chiefly* a theory of high-level aggregates, such as GDP and CPI, but of what is missed in those aggregates: the division of GDP between consumable output and investment-good output is crucial to ABCT, as is the specific makeup of the investment aggregate. Movements in the CPI are not a good indication of the existence–or of the absence–of problems that manifest themselves at the subaggregate level. Accordingly, the conventional macroeconomics aggregates are not the focus of our historical interpretation. As noted by O'Driscoll and Rizzo (1996, p. 190):

> Monetary shocks produce certain types of discoordination in markets. The process of adjusting to these shocks produces effects on aggregative variables. It is not possible, however, to analyze these effects in terms of a standard macrotheory. The level of aggregation necessarily obscures the economic phenomenon being studied. If one were, for instance, to aggregate heterogeneous capital goods into "capital," the complex relationships among capital goods would be lost.

We understand the cycle as described by Mises and Hayek to be an ideal type, which *more or less* explains particular cycles.[2] Praxeologically speaking, we can say that maintaining an artificial interest rate, like all price-fixing, will have unintended consequences that the price fixer can do little to control. But the particular consequences always involve particular historical circumstances.

We believe the events comprising the dot-com boom and bust can be illuminated by tracing the Cantillon effects as new money made its way from the Federal Reserve, through the banking system, and finally to the dot-com startups. This liquidity led them to bid up the price of capital goods that were complementary to their business plans. As those prices rose, it became clear that many of their plans were not feasible. Broad-based price indices, such as the CPI and the PPI, mask such important phenomena as the steeply rising prices for web programmers, Silicon Valley real estate, and Internet domain names–precisely the effects predicted and explained by ABCT.

Consumer behavior during the period shows that, much as Mises (1998, p. 567) described, artificial booms are characterized by both malinvestment *and* over-consumption. In addition to the stock market bubble, the period in question saw increasing consumer leverage, a booming housing market, increasing debt-to-equity ratios, and lower down payments on homes.

The turn that came in 2000 triggered the liquidation of boom-inspired malinvestments. The Federal Reserve attempted to engineer a "soft landing" with a moderate tightening of credit conditions. We suggest that was a problematic solution. The large buildup in consumer debt that since has helped to

[2]For a treatment of key differences between Mises and Hayek, see Garrison (2003).

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maintain housing prices and consumer spending has cast an ominous shadow over the prospects for a smooth recovery.

Finally, we will look at an alternative explanatory framework (which we will call *mania theory*), as it applies to the recent cycle, and demonstrate that while it may complement the Austrian theory, it is not a replacement for it.

ABCT as a Tool of Historical Explanation

Aggregates and ABCT

A chief query from critics of ABCT is, "Where's the evidence?" Often, the critics hope to see a prediction of next year's GDP, or a formal model "demonstrating" that a federal funds rate cut of 0.5 percent will result in, say, a 0.4 percent rise in the CPI. But the evidence by which we judge that a theory is sound can only be the evidence called for by that theory: "Scientific evidence, too, is theory-dependent . . . evidence depends on observations, observations on measurements, and measurements not only on standards of measurement but on theory-determined concepts to be measured" (Nardin 2001, pp. 114-15). In other words, quantum physics should not be judged deficient because it does not predict the outcome of presidential elections.

ABCT is a not a theory of mathematical relationships between economic aggregates. To the best of our knowledge, no advocate of ABCT has ever claimed it could predict GDP or CPI levels. Certainly, it would be a nice bonus if ABCT could predict GDP, CPI, and pick winning stocks for us as well. But as the theory itself does not speak in terms of such macroeconomic aggregates, it is inappropriate to use them as the chief evidence by which to evaluate it. (That is not to say that ABCT has *nothing* to say about macroeconomic aggregates.)

In employing ABCT as a framework for historical explanation, "our focus is on the point of entry of the new money and the consequent changes in relative prices that govern the allocation of resources over time" (Garrison 2001, p. 67). The ideal type we explore, employing that focus, is that of the central bank credit expansion. The pieces of evidence we marshal to comprehend the subsequent economic events are the systemic effects of a lowering of the interest rate, and the changes in relative prices as new money flows through the economy.

The conformity of experience to an ideal type is always a matter of degree (Koppl 1994). A hockey puck moving over ice conforms to the ideal type "a body moving over a frictionless surface" better than does a soccer ball rolling over grass. Still, the type is not useless as an explanatory framework even in the second case. Therefore, we may find certain cycles closely conforming to the Austrian business cycle, while others do so to a lesser extent. We find criticisms of ABCT complaining that it does not explain every fluctuation in macroeconomic measures as odd as we would a contention that it could explain every fluctuation.

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In our view, ABCT can be validly criticized as an ideal type on two grounds:

(1) The ideal type itself is constructed using unsound economic reasoning, so that it is on its face incoherent; or

(2) The theory is economically sound but irrelevant, as no *actual* cycles ever conform to the ideal type it describes.

We will leave it to other works (Mises 1998, 1953; Hayek 1967; Garrison 2001) to deal with the first possible criticism. This paper presents an answer to the second category of complaint, by attempting to show that the recent boom-bust cycle is just such a highly conformant cycle and that ABCT is a great aid in comprehending recent economic history.

Mises (1998, p. 543) describes the relationship between ABCT and historical data as follows:

> There prevails upon the loan market a tendency toward the equalization of gross interest rates for loans for which the factors determining the height of the entrepreneurial component and the price premium are equal. This knowledge provides a mental tool for the interpretation of the facts concerning the history of interest rates. Without the aid of this knowledge, the vast historical and statistical material available would be merely an accumulation of meaningless figures. . . . Gross interest rates as they appear in reality have nothing else in common than those characteristics which catallactic theory sees in them. They are complex phenomena and can never be used for the construction of an empirical or a posteriori theory of interest. . . . They constitute, if carefully analyzed with all the knowledge economics conveys, invaluable documentation for economic history.

And so we will attempt to employ them.

1995-1996: The Boom Begins

Our story of boom and bust begins against a backdrop of generally improving economic conditions in the U.S. in 1993 and 1994. The Plaza Accord of 1985 (Brenner 2002, pp. 59-74) had improved the profitability of U.S. manufacturing, as the G-5 powers[3] agreed to subsidize U.S. exporters by artificially lowering the exchange rate of the U.S. dollar. (Powell [2002] identifies the Plaza Accord and the accompanying monetary expansion in Japan as the beginning of that country's own Austrian-style boom and bust.) The American economy had come out of the recession of 1990-1991 in fair shape, with some of the misallocations of the 1980s boom having been corrected. It seemed investments in information technology were finally paying off, and manufacturing

[3]France, Germany, Japan, the United Kingdom, and the United States.

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productivity was increasing. The stock market began to climb in 1993, and the recovery looked robust enough that the Federal Reserve began to raise rates:

Table 1

Date	*Fed Funds Rate*	*NASDAQ Composite*
1994.09	4.73	764
1994.10	4.76	777
1994.11	5.29	750
1994.12	5.45	752
1995.01	5.53	755

Source: Federal Reserve Economic Data (FRED). (We will show Fed funds rates against the NASDAQ Composite index in these tables, since the NASDAQ is the "tech stock" exchange, and most of the dot-com stocks traded on it.) [4]

But, beginning with the Mexican crisis and bailout of late 1994 and early 1995, the Federal Reserve was faced with a series of financial collapses. Over the rest of the nineties, we find the Federal Reserve oscillating between half-hearted attempts to restrain the equity boom and responding to crises that it believed called for reversing the previous restraint. In the meantime, theories of a "new economy" developed, both inside and outside the Federal Reserve, to justify soaring asset prices. We will establish the backdrop for these events by describing the important "Reverse Plaza Accord."

The Reverse Plaza Accord

Brenner posits the "Reverse Plaza Accord" of 1995 as being an important factor in creating the late nineties boom:

> By that agreement, the big three powers [the U.S., Japan, and Germany] bailed out a Japanese manufacturing economy that was slowing to a halt under the pressure of the record-breaking ascent of the yen. They did so by engineering a striking reversal of the steep decline of the exchange rate of the dollar that had taken place over the previous decade. (Brenner 2002, p. 5)

We agree with Brenner, in that the Reverse Plaza Accord was crucial in determining which prices were influenced the most by the liquidity provided by the Federal Reserve during the boom.

[4]Since we are not attempting to posit a fixed, mechanical relationship between Fed interest rate policy and movements of the NASDAQ Composite index, we will refrain from statistical analysis of the data presented in the tables here. What we are instead trying to establish is that, during the period in question, there was a contingent historical relationship that held between interest rate policy and the run-up in "high-technology" asset prices, due to the fact that much of the increased liquidity flowed into the asset markets –specifically the high-technology asset markets.

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As Brenner describes it, Japanese manufacturing firms were faltering in 1995. "By April 1995, the yen had reached an all-time high of 79 to the dollar. . . . With the currency at such a pinnacle, Japanese producers could not even cover their variable costs" (Brenner 2002, p. 130).

Many Japanese banks were facing insolvency. The U.S. had just gone through the Mexican bailout, and authorities were not enthusiastic about having to face a similar bailout scaled up to the size of the Japanese economy.

The Reverse Plaza Accord was, in effect, an agreement that the U.S., German, and Japanese governments would subsidize American consumers' purchases of Japanese and German manufactured goods. The reversal of the exchange rate trend "was to be accomplished by lowering Japanese interest rates with respect to those in the U.S., but also by substantially enlarging Japanese purchases of dollar-denominated instruments such as Treasury bonds, as well as purchases of dollars by Germany and the U.S. government itself" (p. 131).

Driving the dollar up against foreign currencies would allow the U.S. government to maintain a stance of monetary ease without raising the CPI, since the artificially lowered price of imported goods would tend to counter the price-raising effect of the increased liquidity.

But liquidity has to go *somewhere*. One place it went was into the U.S. stock market. Another was into the asset markets of the East Asian countries whose currencies were tied to the dollar. The perverse effect of the flows was that, even as the manufacturing profitability of American and East Asian producers was undermined by the rising cost (in the yen and in various European currencies) of both their imported capital goods and their exported output, American and East Asian asset prices were given a further impetus upwards, as Japanese and European investors earned profits from both exchange rate movements *and* the rise of the American and East Asian stock markets in terms of the native currencies of those markets.

Given that some of the consequences of this policy appear obvious in retrospect, it is reasonable to ask what the thinking of the people who orchestrated the Reverse Plaza Accord was. The chief motivation seems to have been a desire to undo the previous distortions of the Plaza Accord, especially the decline of German and Japanese manufacturing, without too much pain. Brenner says:

> In a sense, the Clinton administration was favouring suppliers of non-tradable goods, lenders, and stock market speculators at the expense of manufacturers. . . . It may have believed that a slimmed-down, increasingly competitive U.S. manufacturing sector could now successfully withstand a new rise of the dollar. It may have also felt that increasing profitability and economic dynamism in the non-manufacturing sector and growing domestic consumption of manufacturing output would make up for the increasing pressure on the manufacturing sector that would result from rising relative costs in international terms and declining export growth. (Brenner 2002, p. 132)

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Federal Reserve Easing

As the Reverse Plaza Accord was being formulated, the Federal Reserve was also coping with the reverberations of the Mexican debt crisis. Brenner (p. 139) says:

> In March of 1995, following the U.S. bailout of the Mexican economy (and holders of Mexican bonds), the Fed . . . [ended] its credit tightening campaign begun about a year earlier, and, starting in July 1995, it quickly lowered rates by three-quarters of a percentage point. [For the political context of the last of those cuts, see the next section.]

Meanwhile, the technology-heavy NASDAQ Composite began to rise rapidly, crossing 1,000 for the first time ever. The index rose over 27 percent in a 10-month period:

Table 2

Date	*Fed Funds Rate*	*NASDAQ Composite*
1995.06	6.00	933
1995.07	5.85	1001
1995.08	5.74	1020
1995.09	5.80	1043
1995.10	5.76	1036
1995.11	5.80	1059
1995.12	5.60	1052
1996.01	5.56	1059
1996.02	5.22	1100
1996.03	5.31	1101
1996.04	5.22	1190

Source: FRED

The Bank of Japan was easing over the same time period, cutting its discount rate from 1.75 percent to 0.5 percent. The policy of maintaining a large interest-rate differential between U.S. and Japanese central bank rates gave rise to the profitable "carry trade," whereby investors would borrow yen at low rates and reinvest at a higher yield in the U.S. (Brenner 2002, p. 139). The interest rate differential available from the carry trade, combined with the orchestrated rise of the dollar against the yen, meant that as long as the Reverse Plaza Accord held, investors were offered a nearly guaranteed profit by borrowing yen in Japan to invest in U.S. financial assets denominated in dollars. Such an arrangement could not but accelerate the rise in the price of U.S. financial assets. In addition, Asian governments became large buyers of U.S. government securities, helping to send foreign sales of U.S. government securities to several times the level of the early nineties. The already historically

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high $197.2 billion of sales registered in 1995 rose to $312 billion in 1996 (Brenner 2002, p. 141).

The Birth of the IPO Boom

The legendary Netscape initial public offering (IPO) occurred in August of 1995. The IPO is significant because every bubble needs a story, which early investors can tell to later ones to justify rising asset prices. (We do not necessarily mean to impute cynical motives to those early investors. They may or may not have believed the story themselves.) The enormous potential and increasing usefulness of the Internet provided the material for such a tale, and the Netscape IPO was the dramatic lead-in that captured investors' attention.

During 1994 and early 1995, the Internet had begun to enter the broad public consciousness. One of the most prominent companies involved in the transformation of what had been a chiefly academic network into a giant commercial phenomenon was Netscape. Its browser was far and away the most popular interface to the World Wide Web, which itself was the friendliest face of the Internet. Three million copies of Netscape Navigator had been downloaded in three months after its initial release, "making it one of the most popular pieces of software ever launched" (Cassidy 2002, p. 64).

As Cassidy relates (pp. 83-86), by the summer of 1995, Netscape was getting ready to go public, even though it had never made a profit and could not project when it might do so. In July, Morgan Stanley prepared a prospectus announcing the intention to take Netscape public at between $12 and $14 a share. However, during the road show to drum up and gauge interest in Netscape's shares, the promoters found that, at such a low price, the quantity demanded far outstripped the supply of shares. Morgan Stanley raised the initial price to $28, valuing a fledgling, profitless company at more than a billion dollars. The day the stock began trading on the open market, the demand for shares was so high that the Morgan Stanley traders were unable to find a market-clearing price for two hours after the session began. When, at 11:30 that day, Netscape shares finally publicly traded, the stock was priced at $71. It closed the day at 58¼, a first day gain of 108 percent, valuing the company at $2.2 billion. As Cassidy says, "Pretty much everybody involved in the IPO had gotten seriously rich."

The Netscape IPO served as a highly visible symbol for the potential of the Internet, and the potential investor profits that might be gained by arriving at the dot-com party early.

Full Employment but Continued Monetary Ease

The events described above were taking place in a macroeconomic environment that conventionally would be considered to be one of full employment. In the view prevalent at that time, full employment was taken to mean unemployment in the range of 5 or 6 percent. That is, even in the best of times, 5 or 6 percent of the work force would be between jobs or entering the job market for the first time. Full employment simply means that the economy is not in recession. It is possible, of course, for the "full employment"

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unemployment rate to drop below 5 percent, but both theory and recent history suggest that an unemployment rate that low should be considered unsustainable and a symptom of an overheated economy.

This benchmark range of 5 or 6 percent was not particularly in dispute in the mid 1990s (although, as explained in the following section, it came to be disputed later in the decade on the basis of a perceived "New Economy"). The unemployment rate had varied modestly within this benchmark range during the three years preceding the Bush recession. It then broke through the 6 percent level in late 1990, reaching a peak of 7.8 percent in mid-1992. (See Table 3 below.) From that point, the unemployment rate fell, continuing to descend through 1993 and 1994 and leveling off in 1995 just above the middle of the full-employment range. This pattern suggests the actual achievement of the much sought-after soft landing. During the 10-month period from April 1995 through January 1996, the unemployment rate stayed in the narrow range of 5.6 to 5.7 percent.

The role of the Federal Reserve in taking the economy below the full-employment range in the latter half of the 1990s was foreshadowed in early 1993, just after the inauguration of Bill Clinton. His State of the Union Address included conflicting messages. The new president identified two policy actions as essential to the future health of the economy. The first was a stimulant package, which would involve billions of dollars of new public-sector spending projects as well as tax breaks to encourage private-sector spending. The second was fiscal responsibility, which would require decreases in government expenditures and increases in tax revenues. Members of Congress and other invited guests were undoubtedly as confused as was the television audience. How could fiscal stimulation and fiscal responsibility be achieved at the same time? The new president articulated no particular role for the Federal Reserve in resolving the conflicted fiscal stance.

As usual, the audience included the chairman of the Board of Governors of the Federal Reserve System. What was highly unusual was that he was seated, quite strategically, directly between First Lady Hillary Clinton and Second Lady Tipper Gore. The next morning's newspapers contained all the predictable bar charts and pie charts to aid us in understanding just where the economy was and just where it might have been headed. But perhaps the most telling chart that the news media could have presented was the seating chart. Federal Reserve Chairman Alan Greenspan, though initially appointed by Ronald Reagan and reappointed by George Bush, had signed on as a team player in the Clinton administration.

The job of Federal Reserve chairman is inherently a politically sensitive one, but by his public showing of allegiance, Greenspan made the job explicitly and dramatically so. During the first year of the new administration, however, there was no clear conflict between economically sound policy (at least as it was conventionally understood) and politically expedient policy. The economy was still recovering from the Bush recession. Both the conventional wisdom of mainstream macroeconomists and the political interests of the

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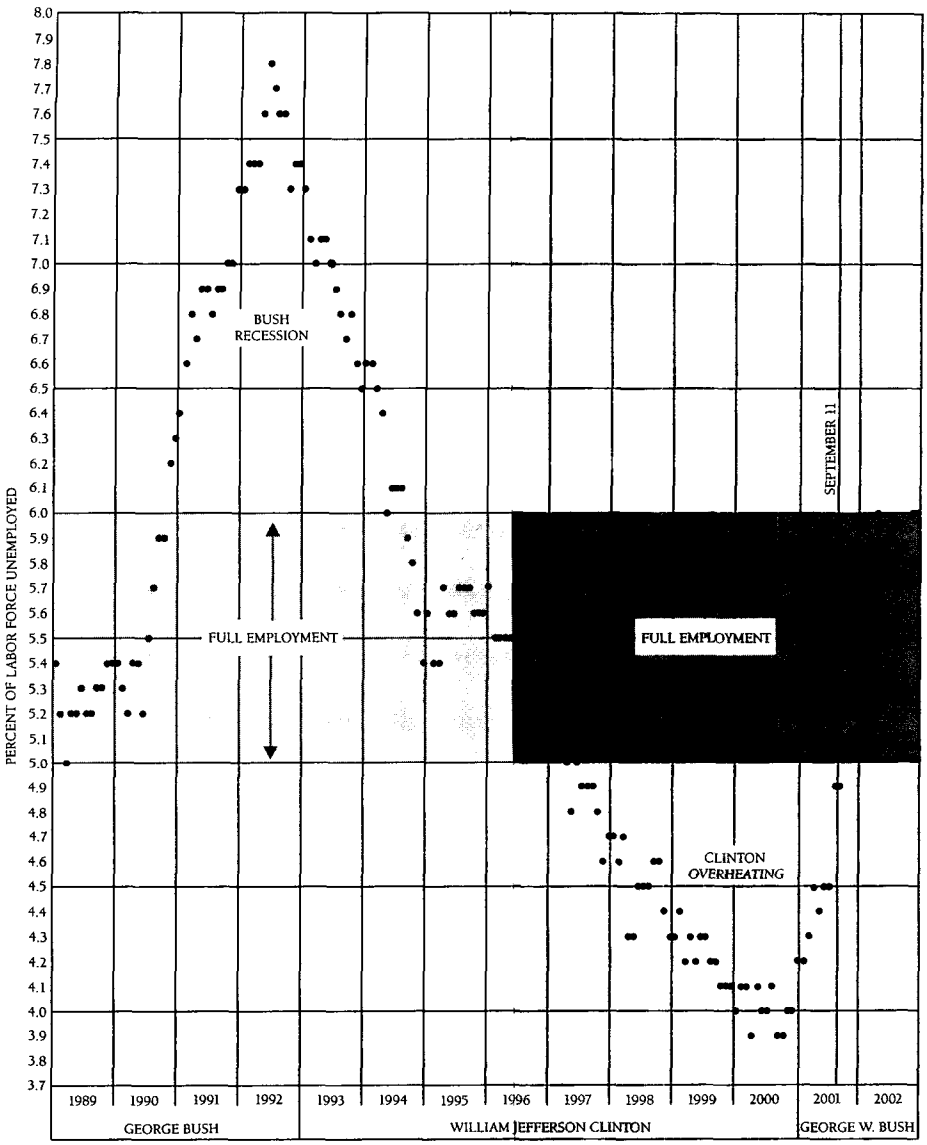
Table 3



House required the Federal Reserve to pursue a course of monetary ease while the unemployment rate was above the upper range of full employment and to exercise monetary constraint as the unemployment rate fell into the full-employment range. Monetary stimulation, followed by a "soft landing" at the 5-to-6 percent level of unemployment, required the solid technical skills that Greenspan seemed to be developing. But those technical skills could only be compromised by political considerations.

Even at full employment, the Federal Reserve can still stimulate the economy, but the effect of such stimulation is temporary. Long-run considerations—of inflation and economic discoordination—warn against monetary

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ease in such circumstances. The duration of the seemingly positive but temporary effects of monetary stimulation—the "overheating"—is believed to be roughly 18 months. The most likely episodes of overheating, then, occur in the 18 months prior to a national election. This is the key implication of modern political business cycle theory and is consistent with the Austrian theory of the business cycle. The period beginning in mid-1995 and extending into 1996, which lies within the critical 18-month window with respect to the presidential election of November 1996 and during which the unemployment rate was near the middle of the full-employment range, provided an important test for the Federal Reserve.

The Fed cut the discount rate in late January of 1996 (see Table 2 above), just before the release in early February of new data on unemployment. The figure for January as initially reported was 5.8 percent—up from December's 5.6 percent. (The 0.2 percent change, like several others discussed below, did not survive the subsequent Bureau of Labor Statistics (BLS) revisions of the unemployment figures.) The mainstream financial press, both then and later, referred to this move in the direction of monetary ease as "questionable" and as "probably unwarranted." There was much justification for skepticism, because the economy was still within the range of full employment, because a single month's increase in the unemployment rate does not usually justify a response by the Federal Reserve, and because the increase in unemployment was easily accounted for by an unusually harsh winter month. (These unemployment figures are seasonally adjusted—which simply means that only a harsher-than-average winter month will affect the adjusted unemployment rate. But January 1996 was just such a harsh month.) While the increase in the unemployment rate, whatever its actual cause, may have provided some "cover" for the Federal Reserve, there was widespread belief that its monetary tools were being wielded against the Republican party and not against the winter storms. The fact that the expiration of Greenspan's second four-year term—and possible reappointment to a third term—fell in March 1996 added an extra element of politics to this particular political business cycle.

The conflict between economic soundness and political expediency was evident the very next month when the unemployment rate fell by 0.3 percent, to the very middle of the full-employment range. If the January figure had provided Greenspan a cover for monetary ease, the February figure had blown that cover. How would the Federal Reserve respond? Would it maintain its monetary ease in light of the upcoming presidential election, or would it tighten to avoid overshooting its target of full-employment. Uncertainty about the Federal Reserve's response was registered, on the day that the new unemployment rate was announced, by a drop in the Dow Jones of 171 points. Good news on Main Street (unemployment down) got translated into bad news on Wall Street (uncertainty-based demands for liquidity up). The Federal Reserve kept the discount rate down, and the episode was replayed just four months later when the unemployment figures for May were announced. Again, the unemployment rate fell by 0.3 percent, this time from 5.6 percent to 5.3 percent. On the day

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of the announcement the Dow Jones fell by 115 points. As before, many investors preferred to get out of the market rather than try to guess what the Federal Reserve would do and expose themselves to the risk of big losses in the event that their guess was wrong. And, as before, the Federal Reserve did not raise the discount rate.

The market does not always react negatively to a seemingly positive development in the economy. The perversity of the Dow Jones dropping on the announcement of a lower unemployment rate is a telling symptom of the politicization of the Federal Reserve. A genuinely strong economy tends to get reflected in higher asset prices on Wall Street. But an economy being spurred on with undue monetary ease is characterized by uncertainty and by volatility in the demands for liquidity.

The particular uncertainty about Greenspan's allegiance to the Clinton administration had dissipated by September, when still a third drop of 0.3 in the unemployment rate was announced. With the presidential election only a few short weeks away and the Federal Reserve committed to monetary ease, the market did not react as it had in the earlier episodes. The Dow Jones actually rose by 53 points. (At the time, however, there was some reading of the tea leaves according to which the market had plummeted the day before the announcement in anticipation of a lower unemployment rate and then rebounded when the news was not as good as feared!)

It should be noted that a 0.3 percent change in the unemployment rate is a large change only in comparison with the typical or average month-to-month change in that statistic. A drop of 0.3 is small in comparison to the width of the full-employment range. Even the cumulative net change (from 5.8 to 5.1) took place wholly within the context of a fully employed economy. And ironically, none of the 0.3 changes survived the revisions that the unemployment statistics—like other macroeconomic statistics—routinely undergo. The currently reported time series for the unemployment rate shows no change greater than 0.2 for the entire 18 months preceding the presidential election. Nonetheless, the announced unemployment rates are the relevant ones in a discussion of the market's reaction to the monthly changes, and these reactions can be understood in terms of market participants having to second-guess the actions of the Federal Reserve in a politically charged environment.

With the interest rates held down at their pre-election levels, the unemployment rate fell to the bottom of the full-employment range before mid-1997 and continued falling for the remainder of that year and beyond. The market continued to be buffeted by growing concern that the Federal Reserve would tighten. Greenspan repeatedly voiced concerns about possible upward pressure on wage rates and worried about the rekindling of inflation. But inflation as measured by the CPI was not nearly high enough (just over 1 percent for both 1996 and 1997) to provide a politically acceptable justification for raising rates. Though temporary, the increased output corresponding to the decreased unemployment rate, aided by the downward drift of the yen and

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mark against the dollar, had countered the upward pressure on prices. Students of the political business cycle might be forgiven for suspecting that Greenspan's fear of inflation was based not so much on any of the leading indicators of future movements in prices or wages but instead on his lingering worries about the ultimate consequences of the unwarranted monetary ease during the Clinton reelection campaign.

Market uncertainties associated with the political business cycle are a problem in their own right. The discussion in the financial press of "interest-rate jitters" is well founded in our understanding of the conflict between economically sound policy and political expedient policy. Traders in securities markets have to keep one eye on the Federal Reserve, trying to anticipate when policy will turn political and when it may turn back towards macroeconomic fundamentals.

The Illusion of a "New Economy"

The idea of a political business cycle can explain the aborted soft landing in 1996. The only alternative reckoning relies on a downward adjustment in the estimated level of sustainable unemployment. Did this range drop in the mid-nineties from its long-standing 5-to-6 percent level to a level that centers on some rate below 5 percent? Some argued as much, contending that the range actually had fallen–as a result, for instance, of changes in the structure of labor markets and changes in labor productivity. The wage demands of labor unions, according to one argument, had become more aligned with economic realities. According to another argument, the economy was just then feeling the effects of the computer revolution. The computer-enhanced productivity of labor had increased labor demand. The corresponding increase in the economy's output had held both wages and prices down and had allowed the achievement of a new plateau of significantly lower unemployment without inflation or an unsustainable boom. Such arguments had some plausibility. At the very least, they served as reminders that the boundaries of the full-employment range are not set in stone, but depend on institutional factors in the economy. But the plausibility of such an alternative reckoning diminished with subsequent movements in the unemployment rate. The whole of the unemployment table above suggests a cyclical rather than a secular pattern. The lows of 1998 through 2000, we contend, were unsustainable lows. To make the alternative claim that the full-employment benchmark dipped down to include 3.8 percent unemployment, achieved twice in 2000, is as fanciful as claiming that it shot up in 1992 as an alternative account of the Bush recession.

When the unemployment rate dropped further and further below the 5 percent level, Greenspan became receptive to the idea that the long-established full-employment range was no longer applicable. The apparent productivity of the labor force had ushered in a "New Economy." The similarity of that phrase to the 1920s slogan, a "New Plateau of Prosperity," seemingly did not attract the notice of the Fed chairman, despite the fact that in his youth

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he had studied and lectured on the Great Depression, employing the Austrian theory of the business cycle.

To understand the so-called "New Economy," Greenspan did not take his cue from the Austrian theory and focus on policy-induced reallocations of capital. Quite to the contrary, he was inclined to assume away all complications concerning capital structure in order to draw conclusions about the productivity of labor. If he could claim that productivity had increased, he could maintain the monetary ease and could even push interest rates down further without worrying about inflation.

As reported by Bob Woodward in his *Maestro* (2000), Greenspan repeatedly indicated that he "believed but could not prove" that productivity had increased on an economy-wide basis. His thinking was organized around an accounting identity that applies, on a disaggregated basis, to particular industries. Looking for confirmation and support, Greenspan summoned some Federal Reserve researchers into his office and wrote out the equation:

$$\text{Price} = \text{labor costs} + \text{nonlabor costs} + \text{profits}.$$

Woodward (2000, p. 173) reproduces the equation and punctuates it with the response of the researchers: "They agreed." As it turns out, economists of all stripes–and, all the more, accountants–would *have* to agree. The above equation, when corrected to refer to per-unit costs and per-unit profits, is a tautology. It simply says that per-unit accounting profits are equal to the price minus the per-unit costs and that these costs can be divided into the mutually exclusive and jointly exhaustive categories of labor costs and nonlabor costs.

But Greenspan made something of it by assuming that nonlabor costs, which, we note, include the cost of borrowing, are constant. Such an assumption is unwarranted and is especially peculiar when made by a Fed chairman, whose very actions change the cost of borrowing. Granting him his assumption, though, we can easily follow his argument: *if* profits were rising, which they seemed to be in the particular industries examined, while neither prices nor wages were rising, which also seemed to be the case, then labor productivity must have been rising. It's a mathematical necessity.

The belief that productivity had increased was transformed into a declaration that we were dealing with a "New Economy," in which the old macroeconomic theories were irrelevant. Having orchestrated the longest boom in Federal Reserve history, Greenspan seemed convinced–except on rare occasions when self-doubt crept in–that such booms do not necessarily lead to busts. Increasing productivity allowed for the simultaneous achievement of low interest rates, low inflation, low unemployment, and sustainable economic growth. Greenspan's view, it turned out, was compatible with the view held by Bill Clinton, who, as Woodward (2000, p. 123) points out, was always quick to ridicule the idea that any economic problems stem from too much economic growth and too many people working.

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Economists sometimes lapse into the misunderstanding that increased labor productivity means that workers have somehow become super-workers. It means no such thing. In general, workers become more productive when they work with more and better capital. At any particular time, in some industries (just which industries depends upon numerous historical contingencies), they will get more and better capital if the Fed reduces borrowing costs. We see, then, that the Fed's own easy-money policies can give rise to a measurable increase in labor productivity in particular industries and to the impression that productivity in general has dramatically risen. Undeniably, there were some productivity gains in the 1990s–just as there were in the 1920s–but concurrent productivity gains in select industries are more likely to be indicative of an unsustainable boom than of an end to booms and busts. Furthermore, many of the purported productivity gains that Greenspan was looking at later proved to be illusory. As reported in *The Economist* (2001):

> [P]art of America's previous surge has now been revised away. According to the old figures, annual productivity growth averaged 3.4% in 1999-2000. That has now been shaved to 2.6%.
>
> Most commentators found relief in the fact that average annual productivity growth in the five years to 2000 had been revised down only modestly, to 2.5%, well above the rate of 1.5% in the first half of the 1990s. On the other hand, Alan Greenspan, the chairman of the Federal Reserve, had placed huge weight on the fact that productivity growth had been accelerating–to 4.3% last year by the old figures. On this basis, he believed that structural productivity growth, after stripping out the cyclical impact of the economic boom, was around 3%. Most of the acceleration in productivity has now vanished. . . .
>
> What is more, recent productivity gains have been exaggerated not just by the cyclical impact of the boom, but also by an unsustainable surge in investment in information technology that has now gone into reverse.

Complicating the picture, for Greenspan and for us, were the repercussions in the U.S. of economic crises in other countries, as well as the fallout from some home grown crises, as explained in the following section.

1997-1998: A Time of Crisis

A series of economic crises–in East Asia, in Russia, in Brazil, and in the U.S. itself with the Long-Term Capital Management failure and the potential Y2K problem–created a situation in which the Federal Reserve felt obliged to supply repeated influxes of liquidity to the market. As a result, after increasing at a rate of less than 2.5 percent during the first three years of the Clinton administration, MZM (money zero maturity) increased over the next three years (1996-1998) at an annualized rate of over 10 percent, rising during the last half of 1998 at a binge rate of almost 15 percent (FRED 2002).

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The problems inherent in the Reverse Plaza Accord first appeared in East Asia in early 1997. A significant portion of the enormous increase in liquidity worldwide, originating primarily from the American and Japanese central banks, had flowed into investments in that region. Between 1990 and 1995, 74.5 percent of capital flows to less developed countries went to East Asia (Brenner 2002, p. 158). Governments there, operating on the mercantilist Japanese model of development, subsidized a rapid industrial buildup, often channeled into certain "strategic industries" such as high tech manufacturing. Because they partially funded the subsidies by borrowing in dollars, they were reluctant to loosen their pegs, as the cost of paying back dollar loans would increase in terms of the local currency.

However, "[b]etween April 1995 and April 1997, the yen fell by 60 percent . . . with respect to the dollar" (Brenner 2002, p. 158). If East Asian governments wished to maintain their peg to the dollar, they had to let their currencies rise against the yen as well. But that led to a steady rise in the price of their exports compared to those of their Japanese competitors. The East Asian countries had committed, willy-nilly, to the U.S. policy of subsidizing German and Japanese manufacturers and their own consumers at the expense of their own manufacturers. However, with smaller economies, manufacturing bases already distorted through extensive subsidies, and without being able to print the world's reserve currency at will, East Asian governments lacked the ability to sustain such a policy as long as their American counterpart.

Corporate profits declined throughout East Asia. In South Korea, for instance, they fell 75 percent in 1996, and went negative in 1997 and 1998 (p. 161). With speculators sensing that East Asian governments could not maintain their pegs in the face of slumping exports, those governments raised interest rates in an attempt to hold the peg. Speculators made repeated runs on East Asian currencies, and capital began to flow out of the region: "Over the course of 1997, East Asia suffered a net decline in capital inflows of $105 billion (from $93 billion inflow to $12 billion outflow)" (p. 163).

When, one by one, the East Asian governments finally surrendered their pegs, the value of their countries' dollar debt rose dramatically in terms of the local currency. The crisis in East Asia "steadily worsened . . . Throughout much of 1998, stock markets continued to fall and, as money flooded out of the region, currencies swooned, placing great pressure . . . on the rest of the world economy" (p. 164).

The crisis spread to Russia in the summer of 1998, when it defaulted on its sovereign debt, much of which was held by U.S. investment banks. "The Brazilian economy started to melt down shortly thereafter" (p. 165). And Japan labored under a "hefty new value-added tax," which, along with other factors, "subtracted . . . the equivalent of 2 per cent of GDP" (p. 165).

Brenner (p. 171) says, "In late September 1998 a major crisis was unfolding in the U.S. The Russian default triggered a flight to quality in the bond market as huge differentials opened up between the interest rate paid on relatively safe U.S. Treasuries and the interest rates paid on less secure corporate bonds."

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Table 4

Date	*Fed Funds Rate*	*NASDAQ Composite*
1998.06	5.56	1894
1998.07	5.54	1872
1998.08	5.55	1499
1998.09	5.51	1419*
1998.10	5.07	1845
1998.11	4.83	1771
1998.12	4.68	1949
1999.01	4.63	2193

Source: FRED

*This low for the period was hit on October 8th. In this single case, we have varied from our practice of simply taking the NASDAQ level at the end of the month, and instead looked at the low that came just 8 days later. By looking at this low we can see the tremendous effect of the October 15th rate cut. A 29 percent decline from the peak of 2014 to the low of 1419 was reversed, resulting in a 35 percent gain between October 8th and the end of the year.

Brenner continues: "The climax came on 20 September, when the huge Long-Term Capital Management hedge fund (LTCM) admitted to the authorities that it was facing massive losses." He adds, "The Fed then made its three famous successive interest rate cuts, including one dramatic reduction in between its meetings" (p. 172).

"[The Fed] also encouraged U.S. Government Sponsored Enterprises—including the FNMA, GNMA, FHLMC, and FHA—to engage in a spate of lending (and borrowing) entirely unprecedented in their history" (Brenner, pp. 172-73).

The between-meetings rate cut had a dramatic effect on stock prices all by itself. Greenspan's announcement of the cut came on Thursday afternoon, October 15th, the day before expiration Friday, when stock options for October expired. The effect of the timing was to give traders who had written call options

> every reason to buy the underlying stocks as soon as possible to limit their losses on the contract. This need for players in the option market to cover their positions immediately . . . would further strengthen the upward pressure on stock prices. . . . From three o'clock Thursday afternoon to four o'clock Friday afternoon, the stock market rose more than 7 percent. (Mayer 2001, pp. 10-11)

Brenner (2002, p. 173) notes that Fed cuts probably produced a stronger effect by signaling to investors that the Fed wanted a market recovery than they did by reducing the cost of borrowing. "Investors," Brenner says, "did not have to be reminded that [Greenspan's] intervention at this moment was hardly the first of his bailouts of financiers and corporations." After the October 1987

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market crash, after the S&L crisis broke in the early nineties, and during the Mexican and East Asian crises, Greenspan had ridden to the rescue of investors, with the goal of preventing troubles on Wall Street from spilling over into the rest of the economy. The market reaction to Greenspan's intervention is typical of the effect of "big players" on markets, as described by Koppl (2002) and others.

The Federal Reserve, during a period of over a decade, had attempted to build a "firewall" protecting the "real" economy from Wall Street shocks. But firewalls work both ways: Protecting the real economy from Wall Street shocks also disconnected Wall Street from the real economy. Hedged on the downside by what could be called "Fed insurance" against falling asset prices, investing on Wall Street began to look better and better compared to investing in the messy "real" economy, where one might lose one's money!

1999–Winter 2000: The Height of Madness

By 1999, the liquidity party was in full swing. The rate on 30-year Treasuries had dropped from a high of over 7 percent to a low of 5 percent. The stock markets continued to soar. The NASDAQ Composite rose over 80 percent in 1999 alone. People who had stayed in the sidelines during the early part of the festivities began to feel left out. With abundant credit being freely served to Internet startups, hordes of corporate managers, who had seemed married to their stodgy blue-chip companies, suddenly were romancing some young and sexy dot-com:

> This week alone, General Motors Corp. Saab Cars U.S.A. chief Joel Manby left his job to become president of Greenlight.com, a new consumer auto site, and ABC-TV President Patricia Fili-Krushel resigned to become CEO of Healtheon/WebMD, a medical consumer site. (Audi 2000)

But what do we mean when we say that the economy had entered an artificial boom? Can an economy grow "too fast"? Can the participants in an economy invest "too much"? One way to answer those questions is to examine the meaning of the production possibilities frontier (PPF).

Beyond the PPF

Garrison (2001, p. 70) asks: "Is it possible for the economy to produce beyond the production possibilities frontier?" He answers, "Yes, if the PPF is defined as sustainable combinations of consumption and investment." Such combinations are sustainable only if enough consumption is forgone to fully fund the investments being planned.

However, during the dot-com boom, Brenner (2002, pp. 189–91) notes:

> [The] inflated collateral [resulting from soaring equity prices] provided . . . the basis for the greatest binge in dis-savings in U.S. history. . . . The resulting explosions of both investment and consumption shot the U.S. . . . economy forward as if shot out of a cannon. . . .

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> Between 1950 and 1992, the personal savings rate had never gone above 10.9 per cent and never fallen below 7.5 per cent, except in three isolated years. But, between 1992 and 2000, it plummeted from 8.7 per cent to -0.12 per cent. . . .
>
> [B]y 2000, households' outstanding debt as a proportion of personal disposable income reached the all-time high of 97 per cent, up from an average of 80 per cent during the second half of the 1980s.

At the same time that consumers were saving less and borrowing more, businesses were increasing their capital spending. For instance, a paper by several Northern Californian organizations reports that venture capital firms invested $50.7 billion in the Bay Area during 1999-2000, which was $35 billion, or 233 percent, over the trend-line increase (Bay Area Council et al. 2002, p. 12).

However, as consumers were not saving enough to supply sufficient quantities of the factors of production that would complement those initial investments, many of them would, in retrospect, appear foolish. Of course, at any particular time, some investments will have been proved, *ex post*, to be unwise. The difference in a time of artificial boom is that there is a large spike in such investments. By the summer of 2002, many people no doubt felt that they had invested far too much money and labor in dot-coms and other high-technology ventures.

Numerous dot-com startup tales illustrate one means by which an unsustainable pattern of investment may be generated. With the promise of stock option riches dangling before them, many people worked a fantastic number of hours in start-up companies, investing their underpaid labor to build the company. Commenting on the work ethic at Value America, Kuo (2001, p. 28) says, "Stock was the currency of record in the Internet age, and Craig [Winn] deftly used it to create extreme loyalty, hard work, and dedication."

Such workers presumably really were producing more, for a time. But those 100-hour weeks were unsustainable in two senses. First of all, there is a physical limit as to how long people can work that much. Second, the hours that many people were working were, *ex post*, not in line with their preferences, given that for many of them the promised riches would not materialize.

IPO Mania

The height of the bubble could, to some extent, be measured by the surge in number and decline in quality of IPOs, especially during 1999. The value of IPO offerings nearly doubled from 1998 to 1999 alone (Levy 2000). Between 1986 and 1990, the San Francisco Bay area saw 90 IPOs, while between 1996 and 2000 there were 390 (Bay Area Council et al. 2002, p. 9).

Before the second half of the 1990s, it was generally considered mandatory for a business to have had at least several profitable quarters before it went public. But by 1999, companies were going public with little more than a sketchy business plan, an Internet address, and a few twenty-somethings who could speak the right lingo.

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Kuo (2001, p. 65) notes that in March 1999:

> iVillage, a conglomeration of news and information Web sites for women, went public at $24 per share. It was up $56 the next day, raising its market capitalization to nearly $2 billion. . . . iVillage lost $43.7 million the previous year on a paltry $15 million in sales. . . . Across the country, Autobytel, with about $23 million in sales and $19 million in losses, saw its stock increase 75 percent on the first day of trading, while raising $100 million for operations.

Cassiday (2002, p. 214) says, "[Priceline.com,] in order to boost revenues . . . had resorted to buying tickets from the airlines at higher prices than customers had offered and making up the difference itself." Kuo (2001, p. 39) describes how Robertson Stephens, Value America's investment bank, told its founder, Craig Winn, "Profits weren't important. The *only* thing that mattered was driving substantial revenue quickly." Of course, any business can attain "substantial revenue quickly" if it is willing to lose enough money on each sale.

Y2K Liquidity and the Final Charge of the Bulls

The stock market, especially the high technology NASDAQ, seemed to levitate as Y2K liquidity hit the market in late 1999 and early 2000. The NASDAQ Composite index moved from 2746 at the end of September 1999 to 5048 on March 10, 2000, an *83 percent rise in under six months*! During this period, the Federal Reserve's target interest rates, which were rising, obscured the fact that the central bank was easing in anticipation of a possible Y2K liquidity crisis:

> During the final quarter of the year, the Fed pumped sufficient liquidity into the banking system to bring down the Federal Funds Rate from 5.5 per cent to below 4 per cent–the widest deviation from its target rate in over nine years –and thereby paved the way for the last frantic, record-shattering upward lunge in the equity markets, which took place in the first quarter of 2000. Bank loans thus raced ahead at a 19.4 per cent annual pace during the fourth quarter of 1999, the highest in at least fifteen years. . . . Simultaneously, the growth of the money supply vaulted to 14.3 per cent, even faster than in the wake of the Fed's moves to calm the crisis of the previous autumn. (Brenner 2002, pp. 180-81)

During what we will roughly designate as "the boom," from June 1995 to March 2000, MZM grew 52 percent, well ahead of real GDP growth of 22 percent (Rogers 2002) for the same period. The interest rate on 10-year Treasuries declined from 6.91 percent to 4.53 percent in October 1998, before beginning to rise again. Rates peaked in early 2000, roughly corresponding to the end of the boom. Corporate Aaa bond yields declined from 8.46 percent at the beginning of 1995 to 6.22 percent in at the end of 1998. (All data but Rogers from FRED.)

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By late 1999, production of business equipment was up 74 percent and construction up 35 percent over 1992, while production of consumption goods had risen only 18 percent. Among manufacturing goods, durable good production had risen 76 percent while nondurable good production had risen just 13 percent (Federal Reserve 2000). "Annual borrowing by nonfinancial corporations as a percentage of nonfinancial corporate GDP darted from 3.4 per cent in 1994 . . . to a previously unparalleled 9.9 per cent in the first half of 2000. . . . As a result, by the first half of 2000, nonfinancial corporate borrowing on an annual basis had more than quadrupled with respect to 1994 and nonfinancial corporate debt as a proportion of nonfinancial corporate GDP had reached 85 per cent, the highest level ever" (Brenner 2002, p. 192). Low interest rates had led to an increased demand for loanable funds and a lengthening of the production process, much as in the model described by Garrison (2001).

Even as low interest rates spurred investment in certain capital goods, they led to a collapse in savings. The personal savings rate declined from an already low 2.1 percent (compared to a long-term trend of between 7 percent and 11 percent, as described above) in 1997 to -1.5 percent by 1999 (Bureau of Economic Analysis 1999). Consumers were increasingly leveraged, especially on their homes. "In 1989, about 7 percent of new mortgages had less than a 10 percent down payment, according to Graham Fisher & Co., an investment research firm. By 1999, that was more than 50 percent" (Priest 2001). The divergence of investment demand and savings supply is exactly the phenomenon described by Garrison (2001, pp. 68-71) as characterizing the "policy-induced boom," where monetary expansion drives a wedge between saving and investment.

Spring 2000: The Tide Turns

The Distortion of the Capital Structure at the Height of the Boom

As so often happens at bacchanalia, when the dot-com party entered the wee hours, it became apparent that too many guys had planned on taking the same girl home. There were too few resources available for all of the plans formulated and funded during the boom to succeed. The most crucial–and most general–unavailable factor was a continuing flow of investment funds. However, even if the Federal Reserve had not tightened, sooner or later the wedge between savings and investment would have manifested itself in an absence of other resources. There were shortages of programmers, network engineers, technical managers, office space, housing for workers, and other factors of production. The rising prices of these factors of production would have brought the boom to an end eventually, whether or not the Federal Reserve tightened credit.

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Real Estate

Commercial land and its improvements are clearly important productive resources. Even residential construction is conventionally categorized as investment, with the housing services yielded by the durable dwelling constituting the corresponding consumer good. However, residential real estate in California's Silicon Valley can be considered as a factor of production in a more literal sense. A company's employees need places to live, and those places must not be unreasonably far from the company's place of business, if the employees are to work on site. When an area, such as Silicon Valley in California, is a particular focal point for a boom, we may expect to see that reflected in the price of both commercial *and* residential real estate in the area.

McCollum (1999, p. 1) tells the tale of a bellwether 1999 home sale in the Silicon Valley area:

> The house on the corner of Lowell and Bryant avenues in Palo Alto is a large 1970s contemporary–four bedrooms, 3 1/2 baths, a swimming pool and almost 3,700 square feet of living space.
>
> It went on the market in early March, and within days a bidding war among four would-be buyers pushed the final selling price to more than $3.2 million–$1 million over the asking price. . . . Driven by a potent combination of factors–low inventory, the area's allure and buyers flush with stock-option money–Palo Alto has become ground zero in Silicon Valley's housing market madness. . . .
>
> Micki Schneider, a member of the Palo Alto City Council and a 20-year resident of the city, had heard the story about the Lowell house. . . .
>
> "You can't help but be astonished by sale prices like that," she said. "And it's not like it's been gradual. Prices have just skyrocketed in recent months."

A similar "skyrocketing" occurred in the commercial real estate market: "Office rental rates have exploded, climbing from $2.10 per square foot in 1995 to $6.75 per square foot in 2000" (Huffman 2001).

Apartment rents zoomed upward as well:

> The increase [in apartment rents] from $920 per month in the fall of 1995 to $2,080 in the spring of 2000 squeezed San Franciscans. . . . The rise in rents presumably reflected an increase in demand for housing, stemming from the influx of wealthy dot-commers. (Huffman 2001)

Rising real estate costs contributed to raising the overall cost of living in the San Francisco Bay Area. Between 1996 and 2000, the cost of living premium for the region increased 12.5 percent faster than in the U.S. as a whole (Bay Area Council et al. 2002, p. 13).

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Labor

The people needed to staff dot-com companies were also rapidly becoming more expensive. As the boom peaked, Audi (2000) reported: "So many San Francisco lawyers were leaving good jobs in big firms to work for start-up Web companies that to compete, some firms doubled the starting pay to $150,000."

Kuo (2001, p. 46) tells of how, within *weeks* of being hired in the summer of 1998, Value America executive Glenda Dorchak demanded, and received, "a lot more stock . . . a significant raise in pay," and a promotion.

Covin (2002) noted: "In the late 90s, there was a sudden increase in programmer salaries as a result of the dot-com boom. Programmers who were earning $45,000 in 1995 were making well over $100,000 by the year 2000."

Davis (2000), writing at the peak of the dot-com boom, said:

> Even though it has minted more millionaires than perhaps any company in history, Microsoft is finding that recruiting employees, particularly in Silicon Valley, is getting harder than ever.
>
> Facing a hiring crunch in California, Microsoft has boosted salaries of its Silicon Valley employees by 15 percent to stem turnover and increase staffing, the software giant confirmed. In other words, a Silicon Valley programmer receives 15 percent more in salary than one based in Redmond, Wash., for doing the same job. In the past, Microsoft has not offered regional cost-of-living raises.
>
> Like a lot of big high-tech companies, Microsoft is finding it increasingly difficult and expensive to land and retain hot employees–particularly at its high-profile WebTV operation.

Davis's tale illustrates how all companies in a boom, even industry giants like Microsoft, which did not rely on easy credit for their existence or for the bulk of their growth, are still forced to compete with companies that are relying on easy credit for access to the factors of production. Since those factors are scarce, established companies must outbid newcomers if they hope to employ them. As Mises (1998, p. 551) put it,

> Of course, in order to continue production on the enlarged scale brought about by the expansion of credit, all entrepreneurs, those who did expand their activities no less than those who produce only within the limits in which they produced previously, need additional funds as the costs of production are now higher.

Internet Domain Names

The prices for notable Internet domain names, considered vital to a dot-com venture, underwent an inflation even more dramatic than was seen in the labor or real estate markets. In 1996, tv.com sold for a mere $15,000 (Wingfield 1997). But the next year, as Wingfield describes it, a "Texas-based company . . . purchased the domain name 'business.com' for $150,000, a figure that "appears to dwarf the selling price of any previous Internet address." By

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December 1999, near the peak of the boom, the very same domain name, business.com, sold for *$7.5 million* (*Online Publishing News* 1999). We doubt that the business plan of many dot-com entrepreneurs factored in that sort of price inflation.

The Dot-Com Collapse

After the Y2K scare was seen to be much ado about nothing, the Federal Reserve renewed its concern about an over-heating economy and resumed its rate increases:

Table 5

Date	*Fed Funds Rate*	*NASDAQ Composite*
2000.04	6.02	3860
2000.05	6.27	3400
2000.06	6.53	3966
2000.07	6.54	3767

Source: FRED

Finally, Greenspan seemed to succeed in puncturing the dot-com bubble, even if the resulting turbulence might have been greater than he expected. From the March peak of 5048, the NASDAQ slid to 2471 by the end of 2000. As bad as the general decline was, the drop in the dot-com stocks was even more precipitous, as illustrated in the following table:

Table 6

Stock	3/10/2000	12/29/2000	8/6/2002
QualComm	136.12	82.18	25.18
Cisco	136.37	38.25	12.07
Amazon	66.87	15.56	13.74
Yahoo!	178.06	30.06	11.50
Priceline	94.50	1.31	2.03
Sun Micro.	94.19	27.87	3.78
AOL	59.00	34.80	9.90
EBay	193.25	33.00	55.27
WorldCom	46.69	14.06	.14*

Quotes from BigChart.com

*Price from 8/5, as WorldCom did not trade on 8/6.

We did not cherry pick the worst performers from the dot-com stocks to create the above table; rather, we selected the stocks of some of the most notable "companies" in the Internet world. Many of the small companies did even worse. For instance, Perkins and Perkins (2001, pp. 289-96) list over two

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hundred dot-com stocks, *every one of which declined over 80 percent* between March 2000 and March 2001.

Capital Reallocation

With the advent of the dot-com bust, the painful process of reallocating resources that were misallocated during the boom began. For some economists, the idea that capital reallocation might involve pain is a bit of a puzzle. For example, Paul Krugman (1998) pronounces the ABCT "intellectually incoherent"–largely because it cannot, per Krugman, answer the question: "[How can] bad investments in the past require the unemployment of good workers in the present?"

The puzzle is a result of viewing capital as an aggregation of homogeneous "stuff." Such a perspective overlooks important Austrian insights: capital goods form an intricate, interlocking structure, and the market process that rearranges that structure is a learning process that necessarily takes time.

The world assumed by theories that treat capital as a homogeneous "thing" is one in which information and resources flow instantly, and without cost, throughout the entire economy. No capital goods are specific to a particular business. But in such a world, why would there ever *be* misallocations, bankruptcies, and so forth? The instant that the opportunity cost of owning a resource rose infinitesimally above the marginal revenue expected from employing it, the resource would be sold, at a price equal to that opportunity cost, to another owner better able to employ it. Marginal revenue would always equal marginal cost, and no one would ever make capital gains or losses. As O'Driscoll and Rizzo (1996, pp. 54-55) point out, such a model "must neglect both the learning and the accompanying processes . . . adjustments must have an infinite velocity and resources must be infinitely mobile for a process to take place at a mere instant."

For instantaneous adjustment to occur, capital goods must consist of a uniform "capital stuff," any portion of which can be relocated anywhere in an instant. It is only under conditions of general equilibrium that such a notion makes sense. In general equilibrium, all plans are coordinated, all prices are equilibrium prices, all productive resources are deployed where they should be, and all necessary knowledge of changing conditions is instantly transmitted to everyone who needs to know it.

But consider a real world example: A few months into the recent downturn, a "For Lease" sign appeared along a busy highway in a commercially developed suburb in Connecticut. The property had been occupied by a landscaping business. A couple of years ago, at the height of the boom, the business had built an extensive series of stone walls and fences in front of their building. Our amateur eye estimated that the owners had put in somewhere between $50,000 and $100,000 worth of landscaping. No doubt, the business in question considered the effort to be an investment, as they were able to advertise the quality of their work on a busy highway.

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Misled by the heightened demand for landscaping services at the height of the boom, the business had not counted on a serious fall in demand when the economy slipped into recession, and homeowners saw the value of their stock portfolios shrink and became more worried about holding their jobs than about whether their yards would make it onto Home and Garden TV.

The "homogeneous stuff" model of capital would suggest that those stone walls and fences should have smoothly "flowed" into new uses called for by the new economic conditions. Perhaps they might turn themselves into briefs for trial lawyers ready to sue Enron, or airport security screening machines. But in the real world, those goods are nearly worthless. A doctor or accountant will move into the office, and while he will surely regard his extensive stone and wood works as quite nice, he never would have built them on his own initiative.

But perhaps we're picking out a very special example, particularly unfair to the case for regarding capital as homogeneous. So instead, let's look at a cement truck. We will imagine that a construction company in Silicon Valley, at the height of the dot-com building spree, purchased the truck. When the bust came, construction work in the Valley dried up, and the company went bankrupt. Whither now the truck?

It is very unlikely that another construction company in Silicon Valley would want it. They had all over-expanded as well, and now they may be looking to sell some of their own equipment. They certainly aren't looking to purchase more. But let's assume that somewhere—say, Texas—there *is* a company that can use the truck. The first thing that has to happen is that the buyer and seller must find each other. Rather than occurring on the very day the Silicon Valley company goes bust, such a process may take weeks or months.

The courts will have their say about which creditors are entitled to what portion of the remaining assets of the bankrupt company. Then the truck is likely to move to a reseller of used construction equipment. It will advertise the truck's availability. The downturn probably will necessitate a drop in the price of cement trucks, but by how much? Unlike in mathematical models, where supply and demand curves shift and a new price simply appears, in a market process view, buyers and sellers must undertake a process of price discovery. The seller will be reluctant to lower the price too rapidly, and so he may be overly optimistic for a time, delaying a sale. As Mises (1998, pp. 576-77) says:

> The piling up of excessive inventories and the catallactic unemployment of workers are speculative. The owner of the stock refuses to sell at the market price because he hopes to obtain a higher price at a later date. The unemployed worker refuses to change his occupation or his residence or to content himself with lower pay because he hopes to obtain at a later date a job with higher pay in the place of his residence and in the branch of business he likes best. Both hesitate to adjust their claims to the present situation of the market because they wait for a change in the data which will alter conditions to their advantage.

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Eventually, when a potential buyer hears of the availability of the truck, he may want to inspect it before putting out the money to buy it. Once the transaction is complete, the truck will have to travel from California to Texas.

All of the above actions take time, and all of them have associated costs. Furthermore, we might note that *none of them involve employing any cement workers.* Eventually, a worker laid off in Santa Clara may find work in Dallas, but his change of residence will also involve time and expense.

In the wake of the dot-com bust, many workers had to make just such treks. For instance, Caldwell (2002) notes, "Santa Clara County's population dropped by 14,276 people between April 1, 2000 [roughly the height of the boom] and July 1, 2001, according to figures released by the U.S. Census Bureau. That is more than any other county in the state."

When we get a cluster of such stories occurring together, as we do when the misallocations of a boom are revealed, we find ourselves in a recession. The lack of instantaneous adjustment to the new conditions means that for a time, some useful resources will be unemployed, while they and the complementary capital goods they need to be productive are reallocated. Furthermore, as Garrison (1997) points out:

> The Austrian theory allows for the possibility that while malinvested capital is being liquidated and reabsorbed elsewhere in the economy's intertemporal capital structure, unemployment can increase dramatically as reduced incomes and reduced spending feed upon one another. The self-aggravating contraction of economic activity was designated as a "secondary deflation" by the Austrians to distinguish it from the structural maladjustment that, in their view, is the primary problem.

The costly readjustment in place of residence made itself manifest in the Silicon Valley housing market. Even as home prices continued to increase in California as a whole, "home prices in the heart of Silicon Valley–Santa Clara County–[were] down 5.3 percent on a year-to-year comparison" (Caldwell 2002).

Apartment rents in San Francisco also tumbled in the wake of the crash:

> Although apartment rents are still higher than in the spring of last year, they have been dropping since the fall of 2000. According to Metro-Rent, a rental-listing service in San Francisco, the fall in rents is unprecedented. Rents tend to rise during the summer and flatten out during the year but never fall. The fall in apartment rents, then, indicates a dramatic bust, as do the rise and fall (or fall and rise) in the other economic indicators we've discussed so far. (Huffman 2001)

By the summer of 2001, the entire Bay Area was feeling the effects of the dot-com crash:

> The number of technology pink slips handed out [in Silicon Valley] since the beginning of the year is approaching 200,000, according to various estimates, and the end is nowhere in sight. . . .

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> "I don't recall ever seeing such a harsh downturn here," Dr. James Forcier, managing director of Bay Analytics, a Silicon Valley consulting firm, told NewsFactor Network. . . .
>
> Forcier said that some high-tech sectors are looking at years, rather than months, before they will fully recover from wounds suffered after the Internet bubble burst.
>
> The slowdown is taking its toll throughout northern California, from the Wine Country region, where summer visits are estimated to be off by about 20 percent, to the posh hotels of San Francisco, where room rates have been slashed by up to 50 percent in many cases. . . .
>
> Commercial real estate prices are reportedly tumbling, off by nearly a third in San Francisco, according to broker Cushman & Wakefield. And the vacancy rate is about 10 percent—mid-1970s recession levels—nearly 10 times higher than it was last summer. (DeLong 2001)

In the above story, we see the downturn affecting both higher-order producer goods (office space) and high-end consumer goods (wine country tours).

Stories of over-consumption based on unrealistically heightened expectations abound, such as this one:

> Just a year ago Kelly Scot Moore was fielding at least one job offer a week in his specialty of video production for the Web.
>
> He was so optimistic about his future as a media specialist at Folsom-based CampusEngine.com that he bought a new car and was seriously looking at ski boats.
>
> But since he was laid off just before Thanksgiving, Moore hasn't had a single job offer, despite the scores of résumés he's sent out. (Swett 2001)

Or this one:

> Bruce Hofmann signed the paperwork for construction on his Colorado dream home in April, only two days before he got laid off from his software sales job. Disappointed but not discouraged, he told his wife and three daughters he'd find new work within 48 hours.
>
> After two months of trolling online job databases for software sales jobs in Boulder and in Denver's northern suburbs, he began considering offers requiring an hour commute or longer. After three months, he contemplated sales jobs outside of software; he even received an e-mail bulletin for a used-car salesman gig. (Konrad 2001)

2000-2002: The Bust Unfolds

During 2001, the Federal Reserve demonstrated—with its 11 interest-rate cuts and a near-desperate MZM growth of over 21 percent (FRED)—that it is difficult to recreate the previous evening's euphoria in the midst of a hangover.

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Maintained by waves of mortgage refinancing, zero-interest auto loans, and continued strength in the housing market, consumer spending stayed strong even as business investment faltered. However, Corrigan (2002) points out the ominous debt shadow looming over consumer finances:

> At the personal level, the ABI [American Bankruptcy Institute] showed record filings for bankruptcy in the last four quarters, with more than 1.5 million, mostly individual, filings being logged for the first time ever. Also, despite secularly low interest rates, we know debt service as a proportion of disposable income is already at a record, even without adding in the personal sector's equivalent of a "special purpose vehicle"–a consumer lease agreement whose contingent cash-flows underpin financial market debt somewhere else in the system.

The terrorist attacks of September 11, 2001, certainly delivered an unanticipated and unwelcome shock to the economy. However, the economy had already slipped into a recession by late 2000 or early 2001, and while the stock market quickly rebounded from its post-September-11th lows, most major indices sunk back below those lows a year later. By the end of September of 2002, the NASDAQ composite index had hit a 5-year low of 1173, down 77 percent from its peak in 2000. The Dow Jones Industrial Average stood at 7,598, off 35 percent from its peak. Unemployment was 2 percent above where it had been at the height of the boom, and GDP growth was an anemic 1.1 percent in the second quarter of 2002.

Table 7

Date	*Fed Funds Rate*	*NASDAQ Composite*
2000.12	6.40	2471
2001.01	5.98	2773
2001.02	5.49	2152
2001.03	5.31	1840
2001.04	4.80	2116
2001.05	4.21	2110
2001.06	3.97	2161
2001.07	3.77	2027
2001.08	3.65	1805
2001.09	3.07	1498
2001.10	2.49	1690
2001.11	2.09	1930
2001.12	1.82	1950

Source: FRED

Mania Theory: A Complementary Explanatory Framework?

An alternative class of explanations for booms and busts, which has been applied to the Internet craze by Shiller (2000), Cassidy (2002), and others,

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might be categorized as *mania theories*. In a mania, investors become entranced by some particular investment–tulip bulbs, French colonial trading ventures, Florida real estate, the "nifty fifty" stocks, or Internet companies–and begin a self-perpetuating process of bidding more for the asset, seeing its price rise, bidding even more for it, and so on. Like a manic-depressive who can only maintain his manic phase for so long before crashing, eventually investors begin to have doubts about the focus of their mania, at which point the bubble bursts.

Commenting on the psychology of such theories is beyond the scope of this paper. Nevertheless, we can say that there is nothing in most mania theories that contradicts an Austrian account of boom and bust. The two theories look at the same phenomenon from the vantage point of two different disciplines: social psychology and economics. They may, in fact, prove to be complementary. The Austrian theory offers a coherent explanation of the onset of the mania–a credit expansion–and the onset of the depression–the cessation of the expansion. After all, the mere fact that people are excited about French-Colonial North America or the Internet cannot create a speculative bubble by itself. The funds to speculate with must come from somewhere, and the Austrian theory identifies where. Mises (1998, p. 583) points out that manias cannot, absent credit expansions, continue for long:

> But even if, for the sake of argument, we were ready to admit that capitalists and entrepreneurs behave in the way the disproportionality doctrines describe, it remains inexplicable how they could go on in the absence of credit expansion. The striving after such additional investments raises the prices of the complementary factors of production and the rate of interest on the loan market. These effects would curb the expansionist tendencies very soon if there were no credit expansion.

On the other hand, mania theories might help to explain the reason that booms often seem to be channeled into certain faddish investments. We believe that Austrian macroeconomics could benefit from a deeper understanding of such ideas.

Conclusion

Austrian business cycle theory, we contend, is essential to understanding the recent boom and bust cycle in the American (and, to a great extent, the global) economy. That does not mean that every recent macroeconomic event is explained by ABCT. For instance, exchange rate manipulation (e.g., the Reverse Plaza Accord) is not a part of standard ABCT, yet it played a key part in the global macroeconomic picture of recent years. However, as long as central banks continue to engage in episodic credit expansion, we believe that ABCT remains a vital component in the macroeconomist's tool chest.

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HAYEK'S POLITICAL ECONOMY: THE SOCIO-ECONOMICS OF ORDER. BY STEVE FLEETWOOD. ROUTLEDGE. 1995.

Mr. Fleetwood approaches Hayek's thought from an unusual angle. His book began as a dissertation supervised by Tony Lawson, a leading advocate of "critical realism" as a philosophy of economics; and our author ardently embraces the faith of his mentor. As Fleetwood sees matters, Hayek after 1960 largely succeeded in grasping the new view, even though he lacked the benefit of instruction from Roy Bhaskar, whom the critical realists regard as the supreme guiding light in all matters philosophical. "There are, then, grounds for ascribing to Hayek the label quasi-transcendental realist. . . . One of the most important developments of critical realism is the Transformational Model of Social Activity (TMSA) . . . Hayek appears to adopt something approaching it" (p. 86).

We can best grasp the TMSA and its blessings by retracing Hayek's path to it. In the 1930s, Hayek was in the grip of positivism. As positivists see matters, causation reduces to correlation: "A causes B" means "Instances of A always precede instances of B." On this view, a cause is on the same level as its effect. It is not an underlying structure that explains its effect, in a deeper sense of "explain" than constant correlation.

Economists who accept this doctrine must confront a severe problem. Correlations of the needed kind are nowhere to be found. If, for example, the price of a good rises, it by no means inevitably follows that the quantity of the good demanded will fall. Suppose, e.g., that the prices of close substitutes for the good rise at an even greater rate. The initial price rise may then, paradoxically, increase the quantity demanded of the good.

Has the law of demand been repealed? Not at all, one might at first think to answer. It holds, as the familiar phrase has it, *ceteris paribus*—other things being equal. In given circumstances, the effects of the law of demand may not be evident, but the law still holds good, when the conditions that govern its application obtain.

Our author finds this escape unsatisfactory.

> The positivist deals with the (real) complicating factors that cause the irregularities in events/actions, by spiriting them away by the often completely fictitious use of axioms of human behavior, assumptions and *ceteris paribus* clauses. The presumption is that a theoretical model is constructed as a "scaled-down" version of reality as it were, a model that captures not every aspect but, in some, typically, undefined sense, the most important aspects of reality. (p. 138)

In brief, the positivist cannot cope with economic reality and flees to simplified models. Fleetwood maintains that, before 1936, Hayek followed exactly this course.

THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 6, NO. 2 (SUMMER 2003): 99–101

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> Prior to 1936, . . . the only domain of reality that Hayek's empiricist ontology permits him to investigate is that of the empirical, that is, he must couch his investigation in terms of the events of experience. This encourages the use of equilibrium as the organizing principle of socio-economic activity. (p. 6)

In the 1930s, Hayek modified his philosophy. He now took account of the meanings economic events have for market actors. No longer was he confined, in positivist fashion, to the surface.

> After 1936 Hayek develops an ontology and epistemology that permits not only events given in sense experience, but also conceptions or ideas held by agents. He now recognizes a further domain of reality, that is, a domain (metaphorically) deeper than, or beneath, the flux of events, namely the conceptions created by agents. (p. 6)

Unfortunately, the new philosophy proved unsatisfactory. If economic events exist only as meanings, the real world has been abandoned. Fleetwood does not attribute to Hayek the odd view that thought literally creates physical goods. Rather, the position, which our author with characteristic inelegance calls "hermeneutic foundationalism," holds "that whilst the existence of an external entity is (of course) recognized, any structure humans perceive in it is the result of the cognitive capacity of the mind, not the objective properties of the entity" (p. 18; emphasis removed).

Fleetwood's story has a happy ending. He detects in Hayek's thought around 1960 a fundamental transition. Hayek now abandoned subjectivism for a position very close to critical realism. No longer is the economist confined to surface phenomena, and the structure he discerns is not the product of his own interpretative activity. Quite the contrary, the economist, on Hayek's post-1960 position, can detect real structures.

It is this new stance that enables Hayek to solve the problem of detecting causation in the real world. No longer need the economist engage in a futile effort to find invariable correlations.

> Once an empirical realist methodology is abandoned, Hayek can shift the focus of economic investigation: he can move beyond the events/actions given in experience . . . to the underlying structures, that is, to the domain of the deep. Lack of perfect regularity between events (i.e.; lack of Humean laws) is simply no longer a problem, because the nature or orderliness is established at the level of the deep. Deep structures act with transfactual necessity and do not therefore become problematic when they do not give rise to event regularity at the level of events. (p. 140)

Structures "really" exist, even if one cannot gain access to them by observation.

The fundamental failing of Fleetwood's book stands revealed in an endnote. Our author informs us, "I shall not be concerned with the traditional debates on Hayek's methodology that focused upon Hayek as praxeologist . . . Hayek as a Popperian and/or falsificationist" (p. 160, n. 1). But Hayek without praxeology is very much *Hamlet* without the Danish prince. By ignoring praxeology, Fleetwood misses a way in which the alleged philosophical differences among his Hayek I, Hayek II, and Hayek III can be reconciled. Instead, he forces Hayekian thought within the Procrustean framework of his own critical realism.

Need one take Hayek I to be a positivist? Hayek in *Prices and Production* seems rather to be arguing in a deductive fashion. Is he not elaborating what I remember him

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often calling in lectures the "pure logic of choice" rather than seeking correlations in the style of Hume?

Fleetwood will no doubt respond that he has already allowed for my point. A Humean on his construal is free to simplify reality by "closing the system" (p. 138); but the deductive models constructed by this means do not accurately describe reality. But is this not entirely to ignore praxeology? As Mises classically elaborated the position, the axiom of action, along with a few subsidiary postulates, is known to be true. What follows deductively from it applies directly to the world. The conclusions of economics, then, are not desiccated abstractions but simple truth.

Our author will not likely surrender. Have I not wrongly assumed that Hayek followed Mises in method? What about Hayek's own statement, "I myself originally approached my subject . . . thoroughly imbued with the belief in the universal validity of the methods of the natural sciences . . . what little training I had in philosophy or method was entirely in the school of Ernst Mach and later of the logical positivists" (p. 158).

Did Hayek learn nothing from Mises? Why assume that he retained his positivist views once he began seriously to study economics? Fleetwood might counter that I have begged the question against him. Have I not assumed that Hayek adopted the sum and substance of Mises's views? The objection has merit, so I retreat to a weaker view. If Fleetwood dissents from the picture of Hayek's praxeological approach here sketched, must he not at least consider it? Our author, instead of looking at authors whom Hayek read, imposes a philosophical scheme derived from his own favorites, Bhaskar and Lawson.

A like failing infects the treatment of Hayek II and III. When Hayek II, following standard Austrian subjectivist doctrine, stresses the meaning of events for economic actors, this does not imply that these events lack any structure of their own. Hayek begins with subjective values and meanings, but he does not end there. What about Hayek's constant talk of the unintended consequences of human action? These consequences surely are not confined to mentally imposed structures. The deep dimension of structure that beguiles our author was present in Hayek's work long before 1960.[1]

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[1]For further discussion of critical realism, see my review of Tony Lawson, "Economics and Reality," *Quarterly Journal of Austrian Economics* 2, no. 2 (1999): 93-96.

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ISSN: 0039-3606

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Economics and Culture. By David Throsby. Cambridge: Cambridge University Press. 2001.

In his earnest book *Economics and Culture*, David Throsby, professor of economics at Macquarie University in Sydney, Australia, attempts to provide a framework within which we can apply economic concepts while thinking about cultural issues. Throsby writes as one who has been in the thick of a relatively new economic field termed cultural economics. He has coauthored *The Economics of the Performing Arts*, a standard text on the subject, and is a past president of the Association for Cultural Economics International.

Much of *Economics and Culture* is a descriptive survey of some of the main currents in the cultural economics literature. Cultural economics is widely recognized as beginning with John Kenneth Galbraith's 1960 book *The Liberal Hour* and the seminal work *Performing Arts: The Economic Dilemma* by William Baumol and William Bowen published in 1966. The reader of *Economics and Culture* will obtain a good sense of how the profession has approached its analysis of cultural issues.

Throsby's goal, however, is much more than a literature review. Indeed, he does not seek to provide an exhaustive review of the state of cultural economics. Throsby's real purpose for the book is to bring the notion of cultural value to the front so that it can share the policy spotlight too often monopolized, in his view, by notions of economic value. He wants cultural value to be given an equal place at the analytical table instead of always being told to take an old cold tater and wait.

Throsby begins his task by distinguishing between economic and cultural value. He begins with the straightforward proposition that economic value is rooted in marginal utility, but mistakenly argues that it can be measured by the price a person is willing to pay for a good. In contrast, cultural value can be defined anthropologically as "a set of attitudes, beliefs, mores, customs, values, and practices which are common to or shared by any group," or more narrowly as "certain activities . . . and the products . . . which have to do with the intellectual, moral and artistic aspects of human life" (p. 4), such as works of the visual, performing, and literary arts. As Throsby outlines his definition of cultural value, he thinks in terms of both of the above definitions.

While the relationship between economic and cultural value is of great interest for those of us who care about our culture, *Economics and Culture* turns out to be a very frustrating book. Throsby makes a number of good general observations, but frequently the details of his arguments either are lacking in logical validity or just plain wrong. Too often he makes unsubstantiated assertions and chooses to press on with analysis even when he admits a lack of validity.

THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 6, NO. 2 (SUMMER 2003): 103-106

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Throsby, for example, is surely correct in distinguishing between economic and cultural value. The two are not the same thing, and economists are unwise if they merely conflate economic and cultural value, especially if rightly including aesthetic value in our definition of cultural value. Throsby, however, does not adequately demonstrate how his definition of cultural value does indeed transcend economic value.

Our author tips his hat to post-modernism by deconstructing his definition of cultural value in identifying six "cultural characteristics" that are sources of cultural value for an activity or thing. These characteristics include aesthetic value, spiritual (or religious) value, social value (the extent that a thing provides people a sense of connection to others), historical value, symbolic value (the extent that cultural objects act as "repositories and conveyors of meaning"), and authenticity value (from the fact that a work is the "real, original, and unique artwork which it is represented to be") (pp. 28-29).

Throsby suggests five methods for determining the level of cultural value present in an object, including contextual analysis; analysis of content; social survey methods; psychometric measurement; and expert appraisal (pp. 29-30). While Throsby often implies that cultural value characteristics are subject to comparison to absolute standards, ultimately he leaves all of the evaluation methods to subjective opinion. Who decides when the context of an object indicates that it definitely possesses cultural value? Whose analysis of content matters? Attitudinal surveys merely identify the perceptions of those being questioned. Which experts provide valid appraisals, and how do we decide? Throsby does not address these questions, but they must be addressed if one wants to keep a meaningful distinction between economic and cultural value.

Indeed, later in the book Throsby gives his game away by asserting that

> the aggregation of individual valuations can be thought of as comprising the total cultural valuation of the idea within the sphere of its circulation. Again despite its limitations, this aggregate could be thought of as indicating the cultural value of the idea and hence of the work. (p. 103)

It turns out that, according to Throsby's definition, cultural value could be purely subjective after all, which makes it a mere subset of economic value, at most a reason why someone might value a good economically, instead of a value set distinct from economic value.

Throsby further tries to distinguish between economic and cultural value by appealing to collective valuation. He argues that the cultural impulse, the motivation people have to produce and experience culture, is a collective impulse, a "desire for group experience or for collective production or consumption that cannot be fully factored out to the individuals comprising the group" (p. 13). Throsby provides no support for this assertion, other than merely claiming that much art is produced and consumed as a group activity "moved by a sense that the group experience transcends that of the sum of the individual consumer responses" (pp. 13-14). Throsby does not justify this claim. It may be true that both artists and connoisseurs do receive satisfaction from perceiving themselves as part of a larger community. This, however, does not demonstrate that there is some mystical, collective will that is driven by collective impulses that are autonomous and set apart from the wills and impulses of the people that make up the group.

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Not surprisingly Throsby's theory of cultural value informs his analysis of almost all the issues he addresses. Alas, the ambiguity he demonstrates when analyzing cultural value is present as he approaches other issues as well.

Throsby does not want to merely develop an academic definition of cultural value. He uses it to develop the concept of cultural capital, which he defines as "an asset which embodies, stores or provides cultural value in addition to whatever economic value it may possess" (p. 46). Accordingly, cultural capital can exist in tangible goods such as buildings, museums, and paintings, as well as in intangible things such as techniques, ideas, beliefs, and customs (p. 46).

Here Throsby correctly recognizes that culture is an intellectual heritage bequeathed by one generation to another. He also correctly reminds the reader of the importance of culture in the sense of beliefs and customs for economic development. However, it is not clear that beliefs, customs, and ideas are best thought of as capital. Capital goods are produced means of production that are separable from humans and their labor. Beliefs, customs, and ideas do not live outside of those holding them, in the sense that a hammer or a drill press exists outside of the worker who uses them.

Even if the concept of cultural capital is a viable one, our author runs into further analytical trouble when attempting to apply the theory of sustainable development as put forth by environmentalists to cultural value and cultural capital.

In doing so Throsby arbitrarily claims that cultural sustainability is a matter of both efficiency and equity, and identifies several principles as being important for the sustainability of cultural capital. It is to his credit that he includes material well-being in his outline of sustainability principles, in that it would be hard to sustain culture without the material resources to do so.

Some principles he lists, however, are less justifiable, and some are just baffling. For instance, Throsby argues that intragenerational equity is important for sustainability. This principle, "asserts the rights of the present generation to fairness in access to cultural resources and to the benefits flowing from cultural capital, viewed across social classes, income groups, locational categories, and so on" (p. 56). Throsby gives no explanation, however, of what equality has to do with sustainability. The history of Western Civilization itself violates this principle. At no time in the history of the West did everyone have an equal share of cultural objects, yet Western culture was not only sustained and transmitted from generation to generation, but also flourished to become the most glorious civilization in the history of man.

Throsby's main concern regarding cultural sustainability, is the principle of intergenerational equity and dynamic efficiency. Intergenerational equity "is used to refer to fairness in the distribution of welfare, utility or resources between generations." A clue to Throsby's attitude is his alternative term "intertemporal distributive justice" (p. 54).

Throsby's argument is essentially a claim that future generations have a right to culture. In order to ensure that their right is fulfilled, cultural development must be sustainable. The stock of cultural capital must not be consumed. Because of the collective nature of cultural value, there is a danger that the free market, supposedly focused only on the self, will fail to adequately provide for a sustainable level of cultural capital. Consequently, policy makers may be called upon to intervene in the market to ensure that cultural capital is maintained at a level that allows for intertemporal justice.

It is precisely on this issue that Throsby's failure to address the objective/subjective debate regarding cultural value is fatal to his argument. Throsby talks of "cultural

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sustainability," as if every part of every culture is deserving of being passed on to future generations. There is no guarantee, however, that expert opinion and societal surveys, to choose just two of Throsby's measurement criteria, will agree regarding what is and is not cultural capital. It is very possible that experts will choose Beethoven, while public opinion chooses Britney Spears. Even if they do agree, how do we know that both will choose Beethoven over Britney? Moreover, if it is only a matter of subjective preferences, even historically informed, why all the fuss? Some culture will be sustained.

Even if all are agreed on some objective criteria, Throsby is in essence arbitrarily taking something that is widely considered a nice thing to have, and turning it into a principle of social ethics, a moral right. Instead of limiting himself to statements like, "If we want our children to enjoy live performances of Beethoven's Ninth Symphony in the future, we need to support education in Western musical culture here and now," Throsby makes future cultural experiences a matter of justice and advocates wealth redistribution to guarantee that right.

Throsby does at least recommend that we should consider the costs of intervention in our decision-making policy, which is more than most "culture advocates" do. He recognizes, for example, that rent seeking quite possibly is a motivation for state arts funding, however, he considers these costs merely in efficiency terms. It does not occur to him that the costs of intervention, including those pocketed by rent-seeking politicians and arts administrators, are also a matter of justice. He does not see that he is calling for robbing the productive Peter to pay the cultural Paul. In his search for supposed justice on behalf of future generations, he does not consider the right of people here and now to keep their own property. He advocates the violation of actual rights to ensure those that he has dreamed up.

In sum, *Economics and Culture* is a serious attempt to bring economic analysis to bear on cultural issues. It is a fine survey of the cultural economics literature and makes a number of good isolated insights regarding the survival of culture. However, these strengths are ultimately more than offset by ambiguous analysis and arbitrary assumptions. The reader still awaits a satisfying economic analysis of culture.

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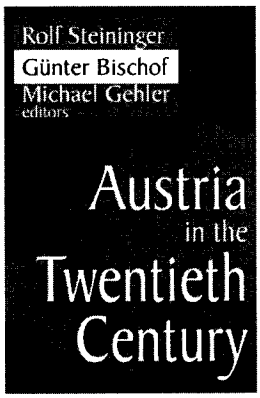

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